# Financial Sector Reforms in Vietnam: Selected Issues and Problems

Jens Kovsted and John Rand and Finn Tarp and Dinh Tai Nguyen and Van Huong Nguyen and Ta Minh Thao

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CIEM
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# Financial Sector Reforms in Vietnam:

# Selected Issues and Problems

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# Abbreviations

| | |
|---|---|
| ADB | Asian Development Bank |
| AMC | Asset Management Company |
| ASEAN | Association of South East Asian Countries |
| BFID | Bank for Investment and Development |
| CAMEL | Capital, Asset, Management, Earnings and Liquidity of Banks |
| CC | Credit Cooperative |
| CCF | Central Credit Fund |
| CIEM | Central Institute for Economic Management |
| EAFC | East Asian Financial Crisis |
| FDI | Foreign Direct Investment |
| FLC | Financial Lease Company |
| FRA | Financial Sector Restructuring Authority |
| GDP | Gross Domestic Product |
| GDS | Gross Domestic Savings |
| GNP | Gross National Product |
| ICB | Incombank |
| ICVB | Industrial and Commercial Bank of Vietnam |
| IFAD | International Fund for Agricultural Development |
| IMF | International Monetary Fund |
| JSB | Joint Stock Bank |
| LEIPC | Legislative and Executive Index of Political Competitiveness |
| LCF | Local Credit Fund |
| NIAS | Nordic Institute of Asian Studies |
| NPL | Non-Performing Loan |

| | |
|---|---|
| PCF | People's Credit Fund |
| PCPI | Prompt Corrective Power Index |
| RAB | Radhanasin Bank |
| RCF | Regional Credit Fund |
| Rosca | Rotating Savings and Credit Association |
| SBV | State Bank of Vietnam |
| SME | Small and Medium-scale Enterprise |
| SOB | State Owned Bank |
| SOCB | State Owned Commercial Bank |
| SOE | State Owned Enterprise |
| US | United States |
| VBARD | Vietnam Bank of Agriculture and Rural Development |
| VBP | Vietnam Bank of the Poor |
| VCB | Vietcombank |
| WDI | World Development Indicators |
| VND | Vietnam Dong |

# 1 Introduction

In terms of level of economic development Vietnam has made significant progress over the past decade. Standards of living have improved significantly, and the country's socio-economic achievements are clearly impressive from a human development perspective. One of the main drivers of economic growth and development has been the implementation of various economic reforms, initiating the transformation from a centrally coordinated and planned economy towards a more market-oriented system. Although the uncertainty and lower economic growth following in the wake of the Asian Financial Crisis caused a temporary slowdown of the reform process, the momentum appears to have picked up again over the last two years.

The financial sector takes centre stage in the renewed efforts to reform the Vietnamese economy. In part because of the extensive linkages between the predominantly state-owned banking sector and the crisis-stricken State-Owned Enterprises (SOEs), and in part because the creation of a more market-based financial sector is expected to improve the mobilization of savings, the diversification of risks, and the allocation of resources in the economy. The current and planned reforms of the financial sector, however, also represent an opportunity to initiate a deeper and more structural break in the way in which the Vietnamese economy is managed. It is only fifteen years ago, during the era of central coordination and planning, that the financial sector was completely subordinate and instrumental to the achievement of government objectives in the productive, state-owned sectors. Although the Vietnamese government has stopped using the financial sector as a direct instrument for the implementation of productive sector policies, considerable indirect government control of financial sector activities persist. It is in this context, that the recently initiated round of reforms bear promise of lessening the persistent (indirect) government control through the creation of a more market-based, autonomous financial sector.

An essential prerequisite to the evaluation and continuation of the current financial sector reforms is that new information and analyses of the financial sector are provided on a recurrent basis. This has not been the case in Vietnam, where the World Bank performed the last comprehensive study of the financial sector seven years ago (World Bank 1995).

Hence, one important objective of this report is to remedy the shortage of comprehensive financial sector analyses in Vietnam. It is, however, important to point out that the present report by no means should be regarded as a follow-up to the 1995 World Bank report. The purpose of this report is to concentrate on performing in-depth analyses of selected issues of prominence and importance for the future success of the reform process rather than describing the current day-to-day operations and procedures in the financial sector. This eclectic approach implies that other important issues such as the development of a payment system, the state and prospects for the inter-bank markets, and the human capital and organisational issues in the state-owned banks are neglected and/or not analysed in depth. They are, however, omissions due to constraints imposed by funds and time available rather than a failure to comprehend their importance. In this context, the present report should thus be viewed as a first step towards establishing an open dialogue about the nature and speed of the financial sector reforms in Vietnam based on recurrent independent assessments of financial sector issues and problems.

When commissioned to perform a study of this nature, one inevitably turns to consider the writings of economists and analysts specialising in the financial sector to see whether an established, commonly agreed upon framework for financial sector analyses exist. This rapidly turns out to be a futile exercise. Establishing a common ground among economists analysing the financial sector and its role in generating economic growth and stability is at best difficult. Views range from support to the Joan Robinson claim that 'where enterprise leads finance follows' (Robinson 1952, p. 86), to those who like King and Levine (1993) hold that Schumpeter was right in suggesting that financial intermediaries promote and accelerate economic growth through the identification of and subsequent allocation of funds to high growth investments. Despite considerable recent progress in both the quality and range of financial sector data available and the methods used to analyse these, this dispute remains essentially unsettled, implying that no clear guidelines emerge here. This lack of analytical coherence also extends to more specific policy related decisions such as: (i) whether transitional economies should develop a securities market-based financial system (as that in place in the United States) or instead opt for a bank-based system (as that in place in Germany), and (ii) whether central bank autonomy should be strengthened through the legislative, political channels or through the establishment of non-governmental interests and powers advocating for lower inflation and increased central bank independence. It is thus important to realise that alternative, competing perspectives exist almost throughout all aspects of financial sector analysis. The approach taken in this report is to note and describe competing perspectives and their associated policy recommendations, while at the same time indicating which perspective/approach we find is best suited to the Vietnamese context.

In addition to consulting recent research on financial sector regulation in developing countries and in Vietnam and South East Asia in particular, the research group responsible for this report has employed the services of two local Vietnamese consultants, Mr. Tri and Mr Diem, who conducted commissioned background studies of the State Bank of Vietnam and the allocation of credit to the different sectors in the economy, respectively. The process of collecting and analysing data and writing the report was based on both desk studies in Copenhagen and field trips to Vietnam. The latter has been of vital importance, as the opportunity to present and discuss ideas and perceptions resulted in new and more productive analyses. The preliminary findings and conclusions were presented at a number of meetings and a seminar held at the Central Institute for Economic Management in Hanoi in October 2002.

Numerous intellectual and creative debts are accumulated throughout the process of making a report of this nature. In this respect special thanks go to the President of the Central Institute of Economic Management (CIEM), Dr. Dinh Van An, his Vice-President Le Xuan Ba, and the Director of the Nordic Institute of Asian Studies (NIAS), Dr. Jorgen Delman. We are also grateful to World Bank staff including Economist Theo Ib Larsen and other colleagues at CIEM and NIAS. All errors and omissions remain, of course, the sole responsibility of the authors.

# 2 Executive Summary

This report is about the difficulties and problems encountered in the process of transforming the Vietnamese financial sector from a centrally coordinated financial system that was subordinate to government objectives and goals in the productive sectors to an autonomous financial sector based on and guided by market forces and competitive pressures.

At the time of writing this report (November 2002), this process is far from complete. This is in part because historical events and structures continue to exert large and significant influence through both formal and informal institutional structures. While the former is in the shape of institutions and assigned tasks, which prevail from previous economic policy regimes, the latter take the form of the general reputation of and trust in the financial sector. Based on the identification of two distinct phases in the liberalisation of the Vietnamese financial sector Chapter 3 contains an analysis of historical determinants and constraints upon present day and future financial reforms.

Phase 1 begins with the banking reforms undertaken from 1988 to 1991 and ends in 1997 with the East Asian Financial Crisis (EAFC). The initial wave of reforms resulted in the creation of a two-tiered banking system through the separation of the large State Owned Commercial Banks (SOCBs) from the State Bank of Vietnam (SBV). In addition, the entry of Joint Stock Banks (JSBs) and foreign bank branches (albeit under restrictions) were allowed. Overall the events in the first phase did little to curb government dominance over the financial sector. The persistent dominance of government controlled financial institutions implied the continuation of the intimate relationship between the SOCBs and the state owned enterprises (the SOE sector). Towards the end of the first period (1988-1997) economic growth and the reform process began to stall. The potential reasons for this slowdown in the growth rate of the Gross National Product (GNP) are manifold, ranging from adverse weather conditions, peasant unrest, problems of moral hazard, lack of incentives in the state owned enterprises, endemic corruption, and an inflexible bureaucracy. The result, however, was a visible deceleration of the economy and the first signs of vulnerability, already prior to severe regional financial crisis, which was waiting in the wings.

The second phase extends from the post-crisis period until today. Although the second phase began with the adoption of the Banking Law in 1998, which formally established the extent of central bank autonomy and abolished the direct political control of interest rates, this phase can be characterized by reluctance towards continuing the deregulation and reform of the sector. Towards the end of the period the pace of reforms has, however, picked up, culminating with the recent (2001) announcement of the forthcoming restructuring and recapitalisation of the four large SOCBs. The second phase can thus be characterized as a gradual return to the more comprehensive and fundamental reforms of the financial sector that were discarded following the East Asian Financial Crisis. It is important to note that most of the more fundamental reforms are still at an initial stage, implying that the official commitment and resolve towards reforms has yet to be seriously tested. In this context, a very important test of the political will to sustain the efforts to introduce a more market-based financial sector is the extent to which the government will seek to restructure and recapitalise the SOCBs and their Non-Performing Loans (NPLs) in particular. Having completed the analysis of both periods, one can identify the following two events in the first phase, as events, which continue to exert considerable influence on present day financial sector dispositions and operating conditions:

1. The virtual collapse and ensuing disappearance of the credit cooperative system during the second half of the 1990s may have had long-lasting detrimental effects upon the general level of trust in the formal financial system.
2. The decision to liberalize the financial sector as one of the first sectors prior to both any attempts to liberalize the SOE sector and a decision to limit/stop directed lending is likely to have contributed greatly to the magnitude of the NPL problems, which are at the heart of the problems facing the financial sector today.

The role of historic factors and path dependency is also identified in Chapter 4, which contains an analysis and regional comparison of the supervision and regulation of the financial sectors. Hence, following a brief introduction to the history of financial sector regulation in Vietnam, the analysis moves to consider the degree to which the regulatory framework in Vietnam is affected by historical determinants. Subsequently, the level of competitiveness measured on the Vietnamese financial sector is compared to other countries in the region and to developing countries in general. In this context, privatisation and entry requirements are considered as key examples of policies that can be used to generate more intensive competition between financial sector institutions. This leads to a comparison of the regulatory framework, the powers bestowed upon the regulator, and the accounting and auditing standards in Vietnam with that found in the countries in the region and to developing countries in general. The more specific regulatory issues such as safety nets, capital adequacy and deposit insurances are subsequently considered and compared in a separate section.

A number of key points emerge from the comparison of the conditions for and the performance of financial sectors in Vietnam and other countries in the region. It is thus found that although Vietnam in recent years has levelled the playing field for new entrants somewhat, there is still much to be done before the Vietnamese banking environment can be characterized as competitive or even partly competitive for that matter. The Vietnamese government should consequently consider policies that could make local financial markets more contestable such as liberalising entry requirements for foreign banks or strengthen efforts to establish gradual or full private ownership of the SOCBs. However, due to respectively the potentially destabilising effects of increased foreign bank presence and the still dormant problem of non-performing loans in the state bank sector it is important that both processes are managed, transparent and gradual.

In addition, the analysis indicates that strengthening the capacity and autonomy of the regulatory framework should be another prerequisite to liberalising entry requirements and financial sector activities in general. More specifically, the analysis presented in Chapter 4 points to the following areas and issues:

- While Vietnamese legislation is equal to or outperforms that of other countries of the region, the autonomy and power to rapidly implement these laws is lacking in Vietnam compared to the other countries in the region.
- The type of activities banks can engage in is relatively restricted in Vietnam. Banks are, for example prohibited from engaging in securities, insurance and real estate markets – activities, which are permitted or only somewhat restricted in most other developing countries.
- Bank accounting standards in Vietnam are below the average level of developing countries.
- Finally, it was found that Vietnam has very restrictive requirements regarding the amount of capital that a bank must have compared to other countries in the region.

These are all areas where the State Bank of Vietnam (the SBV) holds a central position. A central position, which in part rests upon the significance and powers bestowed upon a central bank, and in part on the continued existence of structures and procedures that have remained in place from the epoch prior to the Doi-Moi financial sector reforms in 1988. The historic legacy exists and persists because the process of dual separation from the former mono-bank regime to an autonomous, independent central bank is far from completed in Vietnam. The dual process of separation, where the central bank, on the one side, has to be separated from actual banking operations, on the other, and also has to be able to operate as an autonomous entity on par with the executive, legislative and judiciary branches of government is the subject of Chapter 5.

Again a historic overview establishes how the mono-bank legacy continues to exert considerable influence on both SBV structure and organisation and the degrees of freedom available to pursue SBV objectives. The creation of a two-tiered banking system in combination with the legal base provided by the 1998 Law on the State Bank represents considerable progress in the separation of the SBV from the actual financial sector. Nevertheless, the persistence and importance of the planning legacy is maintained by the fact that the second process of separation, i.e. the transformation of SBV in undertaking the above-mentioned separation from the political system of central planning and coordination, is only just beginning to occur.

This is further documented in the included assessment of SBV independence according to three non-substitutable components of independence, namely: legal, political and operational independence. Here it is concluded that the SBV at present cannot effectively develop and execute national monetary policies. It is still operationally and politically dependent upon support from other government agencies. Hence, although the Law on the State Bank represented a step backwards in terms of restricting stipulated independence compared to the situation prior to the passing of the law it appears more likely that lack of especially political but also operational independence are the more binding constraints.

As a consequence, it is recommended that the pursuit of increased central bank independence in Vietnam should focus more on the indirect route, which entails a gradual build-up and strengthening of a non-governmental lobby for an independent central bank. The preliminary plans for the equitisation of the large state-owned banks represent an important step in this direction, as does the continued presence of foreign banks in Vietnam. In this aspect, the current low level of inflation represents an opportunity in terms of creating an environment conducive to increased central bank independence. The reverse causality argument implies that a central bank uses low inflation as a political lever. Yet, it is also an obstacle, due to the potential lack of a common cause to unite private sector interest in a lobby for a more independent central bank. Nevertheless, given the prevailing political and economical environment in Vietnam, the indirect approach is likely to be a productive and effective approach in the short- to medium-term. In addition, it is recommended that the Vietnamese government considers complementing the indirect approach with more direct measures directed at limiting local authority interfering in credit institution activities – not the least to improve the overall transparency and predictability of the political interference, which takes place.

In terms of the SBV role as facilitator and organiser of financial markets, Chapter 5 briefly considers the current status on the market for Treasury bills, the inter-bank market for domestic currency, and the domestic market for foreign currency, respectively.

In this context, a number of restrictions hampering the further development and growth of the secondary market for Treasury Bills were identified. These included the fact that only T-bills and SBV bills are traded in the market and the fact that the law on the State Bank only allows trade in Treasury bills with a maturity of less than a year. It is moreover stressed that it is very important that the Vietnamese government carefully considers and balances potential gains and risks related to the possible issue of international bonds. Unless such a decision is thought into a detailed and sequenced plan of financial reforms, the increased exposure to the erratic and powerful international financial markets may erase the potential short-term advantages obtained by issuing international bonds.

Another issued in focus in Chapter 5 is whether or not the SBV would gain from the creation of a separate institution responsible for financial sector supervision. The following potential benefits from such a separation were identified:

- The SBV directors and staff will be able to focus efforts and attention on managing money, credit and foreign exchange reserve.
- The separation of the supervisory division from the SBV will serve to increase the distance between the SBV and its former operative functions (the current SOCBs), which will minimize the risk of preferential treatment and/or outsiders attempts to bias SBV policies and rulings.
- The narrower set of objectives is likely to make the quest for increased SBV independence easier and more feasible. Less conflict of interest will occur and efforts can be more concentrated.
- The potential conflicts of interest between the overall monetary policies and the supervision of the banking sector will be made more transparent and will have to be settled through discussions and negotiations between the two institutions (i.e. the SBV and a new independent bank supervision institution). This could for example be a situation where the bank supervision institution in order to better deal with overdue debt in the banking sector would prefer a more expansionary monetary policy.

The above-mentioned potential gains should, however, be weighed against the operational, political and legal obstacles facing the creation of a new and independent supervisory institution. Given that the process of establishing autonomous and independent supervision within the SBV has been underway for some time, the question of whether and when this process is going to end should at least be considered.

Finally, Chapter 5 analyses the problem of non-performing loans (NPL) in the banking sector, more specifically the role and use of a new type of institutions in the Vietnamese financial sector, namely Asset Management Companies (AMCs). Here the following problems related to addressing the NPL problem using the chosen decentralised AMC set-up were identified:

- The existing deficiencies in key national legal and judicial frameworks concerning collateral, land ownership, transfer of loans and creditor rights, land usage rights.

- The need to coordinate NPL assessment and restructuring with ongoing SOEs reforms. This includes tackling potentially powerful and politically connected debtors who might oppose to the process and/or seek to take advantage of the situation and the relatively ineffective legal recourse.

- The potential benefits from establishing linkages to the ongoing efforts to reform and restructure SOCBs. In this context, a central AMC would accord the government with an opportunity to accelerate and guide bank restructuring through, for example, the conditions it attached to the purchase of NPLs.

- The scarcity of managerial and analytical talent in the sector. A single entity will be in a better position to reap economies of scale and make the best use of the human capital available

- The thin or non-existing secondary markets for financial assets make it difficult for separate AMCs to obtain uniform and transparent valuations and conditions of sale. Information is not easily transferred across autonomous decentralised units. A centralised AMC with a more direct government involvement will be in a better position to legitimise the bundling of NPLs and/or to offer discounts if lack of interested buyers turns out to be a problem in Vietnam.

Given the limited and fragmented information about the nature and extent of the NPL in the Vietnamese banking system and the sparse and fragmented information about the specific conditions under which the AMCs will operate, any predictions of future AMC performance and success rates are very difficult. The following three key areas are, however, singled out in Chapter 5 as areas where increasing government and SBV attention would be beneficial: the autonomy and legal power of the decentralised AMCs, the initial assessment and understanding of the NPL problem, and the recruitment and training of skilled personnel.

Chapter 6 provides an overview of the different economic entities and institutions that are currently active in the Vietnamese financial sector. This includes specific problems encountered by the individual types of institutions and their interrelations in the financial market. In addition, Chapter 6 looks at the question of allocation of credit between the government controlled and private enterprises. In this process a very simple typology of intermediate outcomes for the transformation of the SOCBs form state-owned commercial banks into autonomous institutions guided by market principles and forces is introduced. According to this typology, the Vietnamese approach can be characterised as allowing State Owned Banks (SOBs) to pursue an overall objective of profit maximisation vis-à-vis their non-government customers, while at the same time the government reserves the right to stipulate the terms and conditions under which the SOEs receive credit. This in effect amounts to the government transforming bank profits made on private customers into subsidies to the SOEs. As a consequence, any direct subsidies given to SOEs over the state budget can be reduced by the indirect subsidies channelled through the SOBs, and the extent and nature of subsidies given to the SOBs are less transparent to both outsiders and to the government itself. The evaluation of this approach is that it is neither sustainable nor in accordance with the process of equitisation and privatisation of the SOBs.

Finally, Chapter 6 also takes a closer look at financial sector performance vis-à-vis the most important sector in Vietnam in terms of both employment and total output value, namely the agricultural sector. Here special attention is accorded to the Vietnamese Bank for Agriculture and Rural Development as well as to an evaluation of the degree of competition between the financial institutions serving the agricultural sector. The analysis of financial sector services to the agricultural sector finds that the government in effect has laid down an explicit division of labour between the different financial institutions that provide financial services to the rural population. In addition, the local communes, peoples committees and mass organisations play a crucial role in the identification, screening and follow-up on clients for each type of institution. The result is that the initiative to form joint-liability groups and/or to contact to potential lenders comes from the institutions themselves. This reflects a top-down approach, which most likely originates in a desire to divide the market between the institutions in order to extend their outreach.

The competition and segmentation on the rural financial markets are furthermore restricted by the widespread practice of offering subsidized interest rates. While this approach is chosen to improve development opportunities for the rural population, the net effects are highly likely to be negative and detrimental to the overall purpose of improving the livelihood of rural populations. In addition, to severely restricting the mobilisation of savings, the practice of subsidizing interest rates is likely to damage customers perception of credit, lower the overall quality of financial services, and reduce the quality of investment projects financed through the financial sector. All of this runs counter to the government desire to develop and create growth opportunities for the agricultural sector.

# 3 Financial Sector Developments since Doi Moi

The objective of this section is to perform "a historical analysis of financial sector developments since the beginning of the Doi Moi". This might cause some readers to instinctively hesitate. One can identify at least two types of negative expectations that a critical reader might harbour when confronted with a historical analysis of the financial sector. This stems from the commonly held notion of the financial sector as a sector of rapid changes, volatile pricing and frequent structural breaks – a sector for which a historical analysis would appear as almost equivalent to a contradiction in terms and most certainly of limited value for any analysis of current issues and problems. The second is a more general resentment towards the historical analysis as all-illuminating hindsight is granted to all who are patient or arrive late. In other words, historical analysis may be perceived as a non-constructive listing of past failures and miscalculations – an exercise, which can be executed for almost all countries and/or sectors.

The objective of this section is to prove both types of expectations to the historical analysis wrong. Demonstrating why and how historical events and structures continue to exert large and significant influences over the current problems and issues in the Vietnamese financial sector will hopefully do this. In the course of the analysis, important historical channels of influence will be shown to include both formal and informal institutional structures. The former is in the shape of institutions and assigned tasks, which prevail from previous economic policy regimes, while the latter takes the form of the general reputation of and trust in the financial sector.

For this reason, this historical overview of financial sector developments is neither complete nor chronological. Instead, it puts focus on events and structures, which are perceived to have significant and lasting influence, rather than including all developments within the sector in the correct chronological order. Furthermore, as the Vietnamese financial sector throughout the period considered has been dominated by the banking sector, focus will be on this part of the sector. This is not equivalent to saying that other parts of the sector are not important. They are. But regardless of the developments and direction of the near future, banks will continue to play a crucial and dominating role in the Vietnamese financial sector, hence justifying the explicit focus on one type of financial institution.

In line with analyses of the financial sector in other East Asian countries, the development of the banking sector in Vietnam can be divided into two distinct phases:

1. The first phase was initiated by the banking reforms undertaken from 1988 to 1991. These reforms resulted in the creation of a two-tiered banking system

through the separation of the large state owned commercial banks (SOCBs) from the state bank of Vietnam (SBV). In addition, the entry of joint stock banks (JSBs) and foreign bank branches (albeit under restrictions) were allowed. This first phase ended in 1997 with the East Asian Financial Crisis (EAFC).

2. The second phase extends from the post-crisis period until today. The second phase began with the adoption of the Banking Law in 1998, which strengthened the autonomy of the SBV and abolished the direct political control of interest rates. Yet, this phase can be characterized by reluctance towards continuing the deregulation and reform of the sector. Towards the end of the period the pace of reforms has, however, picked up, culminating with the recent (2001) announcement of the forthcoming restructuring and recapitalisation of the four large SOCBs.

As can be seen from even this brief description, the current agenda and approach to financial sector reform is shaped by previous developments and crises in this sector. A more detailed description of historical developments will thus be helpful in the efforts to obtain a better understanding of current issues and problems.

## 3.1 Initiating Transition, 1986-97

The first wave of banking reforms was an integral component of the first substantial economic reforms implemented by the government in the period 1988-1992. These reforms, labelled 'Doi Moi', initiated the transition from a centrally planned to a more market-oriented economy. There had been earlier attempts to loosen government control – most notably the de-collectivisation process in the agricultural sector was initiated already in 1981. However, the Doi Moi reforms launched in 1986 were the first systematic attempt to loosen absolute state control over the economy.

Previous to the Doi Moi reforms the state had a monopoly on all financial transactions as exercised through the State Bank of Vietnam (SBV), which acted both as a central bank and as a commercial bank. In addition to the SBV, the government owned and controlled Vietcombank, a foreign trade bank, and the Bank for Investment and Development (BFID). They were specialized banks and among their primary obligations, they had responsibility for the allocation of funds to state owned enterprises. The financial system was reduced to being an instrument for executing government policies, continuously accommodating the needs of the state budget and the SOEs. A regime of directed and subsidized credit resulted in negative real interest rates and interest rates on deposits were higher than interest rates on loans (interest rate inversion).

The financial sector was, however, not the only sector subject to massive government control, on the contrary. So the Vietnamese government had to determine both the speed and sequence of the many reforms necessary to transform the economy towards a higher degree of market-orientation. The economic literature on economic liberalization and the sequencing of reforms in developing countries is vast and non-unified. This makes it difficult to derive clear, undisputable policy implications. However, one policy recommendation, which emerges quite generally and despite the aforementioned difficulties, is that the liberalization of the domestic real sector should precede the liberalization of the domestic financial sector (Johnston 1994). If relative prices in a non-liberalized real sector are distorted (or perhaps missing), a financial sector guided by market principles will find it difficult (if not impossible) to evaluate the profitability of different client sectors and/or firms for whom they wish to provide credit, see Gibson and Tsakalotos (1994).

The Vietnamese government did, however, not heed to this advice, choosing the financial sector as one of the first sectors to be liberalized as part of the comprehensive efforts to reform the economy. While it is difficult to trace and/or estimate the precise implications of this divergence from the recommended sequencing of reforms, the Vietnamese financial sector is still struggling with the lack of transparency and the lack of market incentives that continue to characterize the only partly liberalized State Owned Enterprise (SOE) sectors. One can therefore point to the initial choice of reform sequencing as one of the structural decisions of the past, which continue to exert considerable influence even today.

The establishment of a two-tiered banking system through the transformation of the former mono-bank into the State Bank of Vietnam and two new specialized SOCBs in 1988 marks the beginning of the structural transformation of the Vietnamese banking system.[1] The new SOCBs that were established included the Vietnamese Bank for Agriculture and Rural Development (VBARD) and the Industrial and Commercial Bank of Vietnam (ICVB).

Another general finding that emerges from other studies of economic liberalization in developing countries is that any transformation of a state-controlled mono-bank system into a diversified market-based financial system is a lengthy and laborious process.

[1] The stipulated sectoral specialization of the four SOCBs was lifted in 1990.

Vietnam is no exception. Despite the creation and entry of a large number of new banks the dominance of the government-controlled banks was not reduced significantly over the first period. This is perhaps best illustrated by the fact that the SOCBs directly under government control still extended 78.4 percent of total non-government credit in 1997.

Moreover, despite the fact that the creation of the VBARD held the seeds for an implicit recognition of the growing importance of private initiative within this sector, the state owned commercial banks in effect continued to serve only SOEs (Le Roy and Robert 1999). The public banks thus essentially failed to fill the growing demand for credit from especially the newly liberalized agricultural sector, which resulted in rapid growth of credit cooperatives in especially the rural areas. The resurgence and even faster demise of the credit cooperative system in the first phase of the Doi Moi reforms is another example of a structural change that has had lasting and very important implications for the Vietnamese financial system. It is therefore useful to elaborate on conditions and developments in this area.

By the time the number of Credit Cooperatives (CCs) began to grow rapidly in the mid-1980s they were well known and established financial institutions in Vietnam. The first credit cooperatives were established in North Vietnam in 1956 and they numbered 5,500 already in the early 1960s. By 1983 the first CCs were established in South Vietnam, and their number continued to grow rapidly during the mid-1980s. By the end of the decade their number stood at 7,180.

The credit cooperatives of this epoch were operating in isolation in small communities beyond the reach of the former mono-bank. Often the sole source of funding in the local areas, the credit cooperatives attracted the majority of the local savings by offering very attractive rates (sometimes up to four times the rates on offer from other financial institutions).[2] Unfortunately, staff in charge was often poorly trained, and a number of cases of fraudulent behaviour had been reported. Moreover, the tradition of operating in isolated communities was continued in the initial round of financial sector reforms, as no automatic refinancing by the SBV was ensured prior to the rapid growth of the CC system. Some refinancing by the SBV was available, but it was neither automatic nor predictable.

Early during 1990 the first credit cooperatives began to encounter problems. The fact that the initial round of reforms contained a significant element of anti-inflationary policies (including sharp increases in the interest rate, a devaluation of the exchange rate, and

[2] Le Roy and Robert (1999) citing from Fallavier (1998)

limits to credit expansion) made the overall conditions for the cooperatives more difficult. In addition, the government also implemented a number of measures intended to reduce the overall fiscal deficit through the elimination of budget subsidies, the reduction of credit to state enterprises, as well as streamlining the bureaucracy. The enforcement of these reforms contributed further to the collapse of the credit cooperatives, as refinancing by the SBV became less dependable and a number of agricultural cooperatives had to close as government subsidies dried up. With arrears mounting depositors panicked and rushed to withdraw their money, triggering a run on credit cooperatives throughout the country.

The overall effect on the credit cooperative system was disastrous. The lack of refinancing facilities, back-up funds and deposit insurance implied that the majority (over 7,000) of the isolated credit cooperatives went bankrupt resulting in massive and devastating losses of savings of especially agricultural households.

By the end of 1990 only 160 credit cooperatives were operational, the rest had closed due to mounting arrears. In addition to the agricultural households that had lost their savings, the collapse of the credit cooperatives in particular affected newly established Small and Medium-scale Enterprises (SMEs) as one of their main sources of credit disappeared. The major long-term effect, however, appears to have been a psychological effect. The collapse of the credit cooperatives severely undermined the general faith and confidence in the formal financial system. This loss of confidence in combination with the negative real interest rate in the early 1990s caused many to withdraw their deposits from the formal sector to buy gold and dollars (see below for more information about the role and significance of dollarization in the Vietnamese economy).

The government reacted to the crisis in the credit cooperative system by strengthening the monitoring role of the SBV and by granting more autonomy to the SOCBs to create a more competitive environment. These measures were primarily designed to prevent the spread or repeat of the crisis, while little was done to amend the damages caused directly by the CC collapses.

Another area where the government reacted directly in response to the credit cooperative crisis was in the attempt to fill the financing gap caused by the virtual disappearance of the credit cooperative system. Hence, the newly formed VBARD was strengthened and by decree no. 202 of 6 August 1991 given the task of lending directly to peasant families.

The VBARD[3] could not, however, fill the void from the collapsed rural credit cooperatives, leading the government to entrust the SBV with the creation and organization of an entirely new (replacement) network of local credit windows. As the primary objective was to re-establish confidence in the financial sector the term 'cooperative' was discarded, opting instead for the term "People's Credit Funds" (PCFs). After a study of the options available in several countries, the government of Vietnam selected to adopt the Canadian Desjardins model[4] to a Vietnamese context.

The result was a hierarchical organization in three management levels. Local Credit Funds (LCF), which were meant to effectively supplant the former credit cooperatives would be handled and directed by a Regional Credit Fund (RCF), which in turn would be supervised by a Central Credit Fund (CCF) handling the supply and balancing of liquidity among the regional funds. If the distance from a LCF to a RCF were too long – the LCF would be managed directly by the SBV. The future vision was, however, that each LCF should be associated with a RCF. The rationale underlying the choice of a three-layer organization was to achieve the combination of close local contacts and connections while minimizing the risks associated with seasonality and regional shocks, which can become an urgent problem especially when the sources of income of members are homogeneous.

The intention underlying the creation of the PCF system was that it should be developed both from above (the SBV) and below (the founding members who are identified with the help of the local people's committee). Most initiatives to start up new LCFs have, however, come from the SBV, which has also provided intensive support in control, supervision and training of staff, in particular during the implementation stage.[5]

While addressing and seeking to constrain the crisis in the CC system throughout 1990, the government also found time to pass new legislation intended to further the diversification of the financial sector. The banking decrees passed in May 1990 thus allowed further (albeit limited) foreign bank participation and the progressive establishment of 54 joint stock banks (JSBs). Many of the latter did, however, supplant already existing credit cooperatives.

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[3] To signal its new role in the economy the VBARD was renamed the Vietnam Bank for Agriculture (VBA) in November 1991.

[4] For more information see: http://www.did.qc.ca/Ang/default.html

[5] See Section 6.3 for additional information and an analysis of current problems facing the PCF system.

Overall, the events in the early 1990s did little to curb government dominance over the financial sector. The PCF system was not an independent, non-governmental alternative and the conditions under which foreign banks were allowed to enter the Vietnamese market were so restrictive that the foreign banks appear to have ended up serving only foreign firms operating in Vietnam.

The persistent dominance of government controlled financial institutions implied the continuation of the intimate relationship between the SOCBs and the state owned enterprises (the SOE sector). One manifestation of the close nexus between the SOCBs and the SOE sector was the allocation of a large share of total credit that went to state owned enterprises (SOEs).[6] The intimate relationship between the SOCBs and the SOE sector is believed to have adversely affected the strength of the banking sector in the following ways:

- The SOE sector was characterized by low efficiency and resulting difficulties in servicing their debts, which caused a deterioration of especially SOCB balance sheets. According to official statistics from the SBV the SOCBs held 75 percent of total overdue loans in 1997. A total 33 percent of total overdue loans were owed by SOEs (principally to SOCBs). It is, however, likely that official figures underestimate the magnitude of the problem given that ever-greening (rolling over overdue loans into new loans) of especially SOE loans was both allowed and widely practiced. In addition, loan classification in Vietnam did not follow international practices and definitions during this period. Instead of classifying the entire loan as non-performing in the case of defaulting payments, the Vietnamese approach up until recently appears to have been to classify the only actual arrears as non-performing while maintaining the remainder of the principal as active and performing. Even without any ever-greening it is clear that such accounting practice will result in estimates of the ratio of non-performing loans to total loans that are much lower than standard international practice. The problem of the non-performing loans in the SOCBs and the recent measures to resolve these are discussed in Section 5.5.

- Directly related to the above-mentioned recent measures addressing the non-performing loans is that the high concentration of SOCBs loans given to SOEs. They were in addition concentrated within certain sectors implying that risk exposure for these banks was (and remains) very high. Allowing SOCBs to

[6] In 1997 the SOEs received 40.2 percent of SOCB credit and 47.2 of total non-governmental credit

provide unsecured loans and having non-standard and non-transparent provisioning rules have further aggravated the problem. This in turn results in bank viability and financial sector stability being crucially dependent upon how the non-performing loan problem is resolved.

- The extensive direct government control of credit allocation and control implied that staff skills and knowledge of creditor screening and supervision became superfluous. As a consequence, specialized staff skills and knowledge about for instance loan assessment and provisioning was not generated and/or maintained.

The above-mentioned problems in the banking sector became visible already during the first period (1986-1997). However, the close relationship between the Vietnamese banking and SOE sectors in combination with the government emphasis on social stability implied that a reform of the SOE sector had to lead or at least be simultaneous with any attempt to tackle the banking problems. A situation where banks, following a banking sector reform, would refuse to extend credit to non-reformed SOEs was not politically acceptable. It would most likely result in financial problems and massive layouts in the SOE sector, which in turn could jeopardize the social and political stability of the country. The significance attached to maintaining social stability and the implications for the limited latitude for financial sector reforms was to become even more evident in the period following the East Asian Financial Crisis in 1997.

Despite the fact that the above-mentioned problems became visible during the first phase (1986-1997) the economy overall reacted positively to the Doi Moi reforms. Annual GNP growth almost doubled from a level around 5 percent in 1990 to 9-10 percent in the peak years of 1994-1996 (see Figure 3.1).

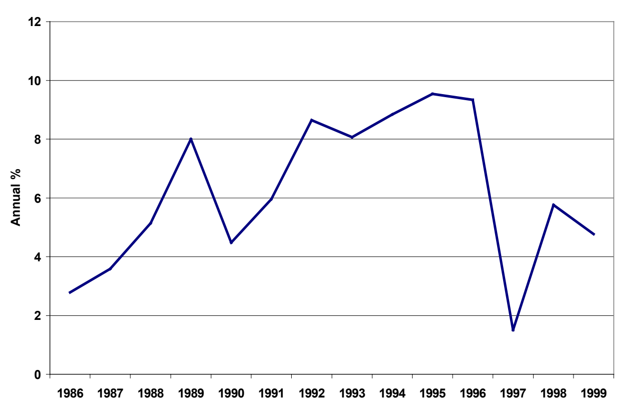


**Figure 3.1: Gross national product (GNP) (annual growth in percent)**

Source: WDI (2001)

Towards the end of the first period (1988-1997) economic growth and the reform process began to stall. The potential reasons for this slowdown in the GNP growth rate are manifold. They range from problems of moral hazard and lack of incentives in the state owned enterprises to endemic corruption and an inflexible bureaucracy leading to an inefficient state. Moreover, in 1997 the country was hit by the worst tropical storm in fifty years and widespread peasant unrest erupted in the northern province of Thai Binh – factors, which undoubtedly contributed a loss of confidence. The result was a visible deceleration of the economy and the first signs of vulnerability, already prior to severe regional financial crisis, which was waiting in the wings.

The acceleration of the GNP growth rate was, however, not the sole positive development during the first period. Inflation, here measured by the deflator of the Gross Domestic Product (GDP), fell markedly from triple digits as experienced in the 1980s to single digit rates towards the end of the first period.

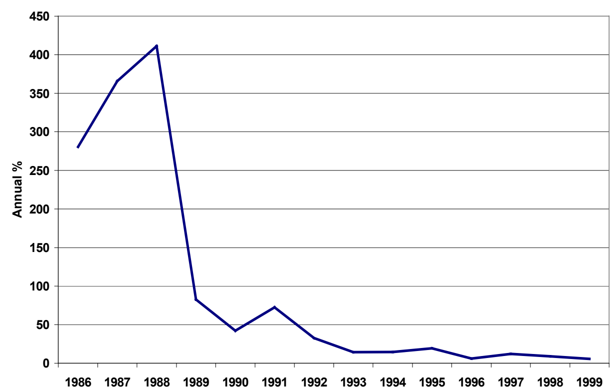


**Figure 3.2: Inflation (annual GDP deflator)**

Source: WDI (2001)

The fall in inflation was followed by a parallel fall in interest rates resulting in positive real interest rates and the end of interest rate inversion (deposit rates being higher than lending rates). On the negative side, the crisis in the (private) credit cooperatives coupled with a history of government control and lack of transparency provides possible explanations for the comparatively low mobilization of savings through the formal financial sector in Vietnam as depicted in Figure 3.3.

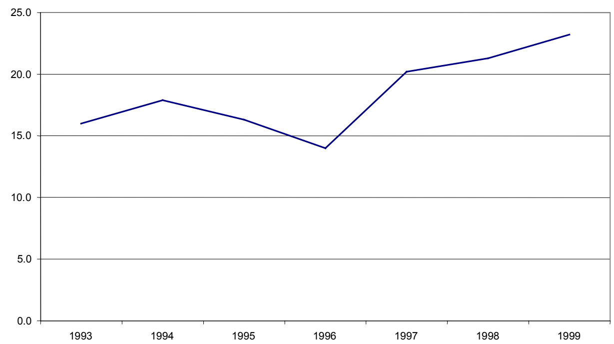


**Figure 3.3: Gross domestic savings (GDS) (percent of GDP)**

Source: WDI 2001

As can be seen from Figure 3.3, the ratio of gross domestic savings to GDP in Vietnam was below 20 percent throughout the first period, which compares poorly to neighbouring countries like the Peoples Republic of China (gross domestic savings around 42-43 percent of GDP) and Thailand (gross domestic savings between 31-35 percent of GDP).

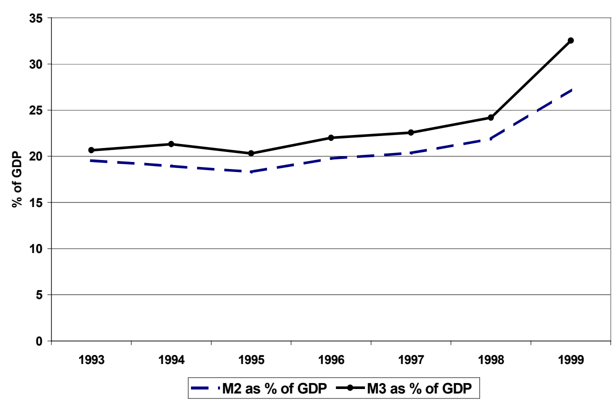


**Figure 3.4: Financial depth (M2 and M3 as share of GDP in percent)**

Source: WDI (2001)

Figure 3.4 depicts another very interesting aspect of the Vietnamese financial sector, which has remained virtually unchanged throughout the period: the almost constant and relatively small difference between M2 (defined as cash holdings plus on-demand deposits) and M3 (defined as all liquid liabilities. This indicates that financial instruments and financial intermediation plays a minor role in comparison to cash when it comes to handling transactions. Towards the end of the period depicted in Figure 3.4 one can, however, detect what could be the beginning of a rapid growth in M3, which could indicate a higher reliance on and use of the formal financial sector.

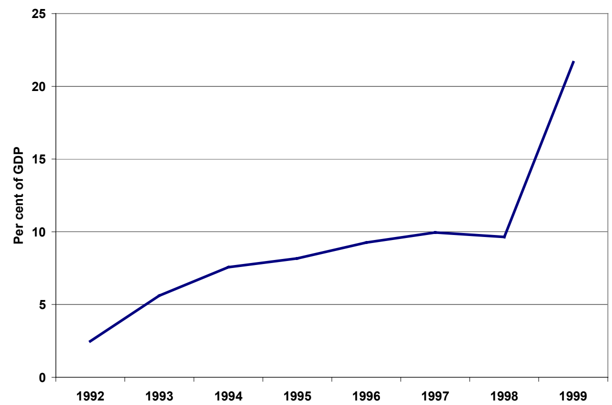


**Figure 3.5: Credit to the private sector (percent of GDP)**

Source: WDI (2001)

This can be seen from Figure 3.5, indicating that the credit to the private sector increased rapidly in 1999.[7] Returning to the lack of financial depth reflected in Figure 3.4, one can speculate as to the possible explanations. In this context, an obvious candidate is the above-mentioned limited trust in the formal sector, which was triggered/reinforced by the defaults in the credit cooperative system. Another aspect of the Vietnamese financial sector, where the supposedly limited trust in the formal sector is also proposed as a possible explanation, is the degree of dollarization.

In general one can identify two, not necessarily conflicting explanations as to why Vietnamese residents choose to hold United States (US) dollars as a supplement to or instead of Vietnam Dong (VND):

- Dollars are used as a medium of exchange. Here the driving factor is the opportunity cost of holding domestic currency instead of dollars, which may rise significantly during periods of macroeconomic instability and high inflation leading residents to demand more dollars.
- Dollars are used to store value. Here a key factor is residents' desire to minimize their portfolio risk and variance. This implies that prudent savers and investors increase dollars holdings if their expected inflation rate diverges from the expected real exchange rate movements.

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[7] The allocation of credit between state and non-state enterprises is analysed in Chapter 6.

The problems associated with a high degree of dollarization are twofold. First, the existence of a parallel currency system will make it more difficult for the government to conduct monetary policy as the shifts in demand and supply of dollars is difficult to predict let alone control. Second, the use of dollars will undermine the revenue the government derives from seignorage, corresponding to the amount of real resources appropriated by the government by means of printing money, and from the implicit inflation tax imposed on holders of domestic currency by inflation.[8] For these reasons governments have frequently sought to limit or prohibit the use and holding of dollars, which in turn has made the phenomenon very difficult to track and measure. Vietnam is no exception, and no estimate of the precise amount of dollars circulating in the Vietnamese economy exists. Instead, the ratio of legitimate foreign currency deposits to total deposits is often used as a proxy for the degree of dollarization. The underlying assumption behind this choice of proxy variable is that although the ratio of foreign currency deposits probably does not reflect the level of dollarization it might give an indication of the trend and movements in the degree of dollarization.

According to Leung and Huy Duc (2000) there were no significant holdings of dollars in the country in the decade prior to 1985.[9] This, however, started to change as the barter trade with the Soviet Union began to decrease and domestic inflation accelerated from 1986 (see Figure 3.2), leading to increased demand for US dollars. Unteroberdoerster (2002) supports this, finding that the 'medium of exchange motive' is the most likely explanation for the rapid rise in foreign currency deposits in the early 1990s. As for the increase in the FDCs from 1996 Unteroberdoerster, however, points to the 'store of value motive' as the most likely explanation given the fact that the inflation was under control in this period (see Figure 3.2) and that the EAFC and lower economic growth made agents uncertain of the government will and capacity to defend the exchange rate. Finally, Unteroberdoerster suggests that a more recent increase in dollarization (not depicted here) appears to have been caused by a combination of asset substitution and increased integration with the global economy.

[8] Historically, the limited success in collecting income taxes in combination with the relatively recent introduction of VAT (in 1999) has implied that seignorage has been a very important source of government revenue in Vietnam. This further acerbates the importance of reducing the level of dollarization in the economy.

[9] The only exception is the South during the American War.

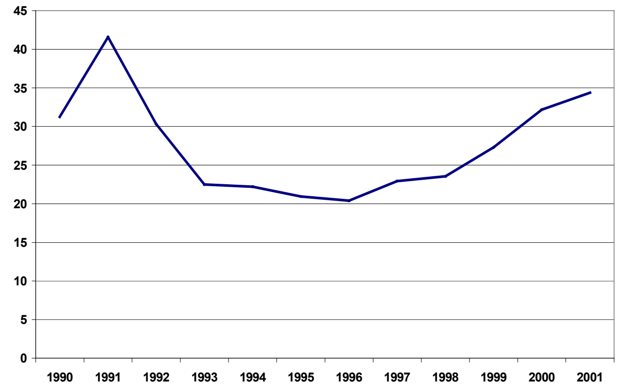


**Figure 3.6: Foreign currency deposits (percent of M2)**

Source: IMF (2002)

More specifically, Unteroberdoerster (2002) points to the following potentially explanatory factors:

- Renewed confidence in the financial sector and the lack of alternative interest-bearing financial instruments.
- Increasing expectations of devaluation – residents are going for safety.
- Relatively strong export performance in recent years.
- The interest rate differential, which earlier favoured VND deposits, has disappeared.

The recent increase is all the more remarkable in light of the fact that the SBV recently tightened legislation in order to make it less attractive for banks to offer foreign currency deposits. As can be seen from Figure 3.6, the increase in dollarization and the overall decline in economic activity (see Figure 3.1), began prior to the EAFC. Hence the Vietnamese economy was already in crisis by the time the regional crisis broke out.

## 3.2 The East Asian Financial Crisis and its Aftermath, 1997-2002

The absence of a liberalized capital account in combination with an inconvertible currency spared the Vietnamese banking system from the detrimental impact of volatile capital flows and institutional distress. In contrast to countries like Indonesia, Korea and

Malaysia, the Vietnamese banking sector was to a large extent shielded from the direct effects of the East Asian Financial Crisis.

One of the observed direct effects of the crisis was that enterprises, expecting a devaluation of the VND, chose to hold foreign currency rather than sell it to the banks. This led to an excessive demand for foreign currency on the inter-bank market, which left the SBV with the burden of supplying foreign currency until a decree was passed requiring firms to sell 80 percent of their foreign exchange to banks (this was later reduced to 50 percent). The SBV furthermore decided upon a 10 percent devaluation of the official exchange rate to the US dollar in August 1998, thereby reducing the perceived pressure for VND devaluation and the demand for foreign currency.

The principal indirect effect of the EAFC on the financial sector was a deterioration of bank assets as bank customers and debtors experienced falling export earnings and/or a reduction in foreign direct investments. As can be seen from Figure 3.7, Foreign Direct Investment (FDI) had, however, already begun to fall in the years leading up to the crisis – possibly reflecting the aforementioned already visible structural problems in the Vietnamese economy.

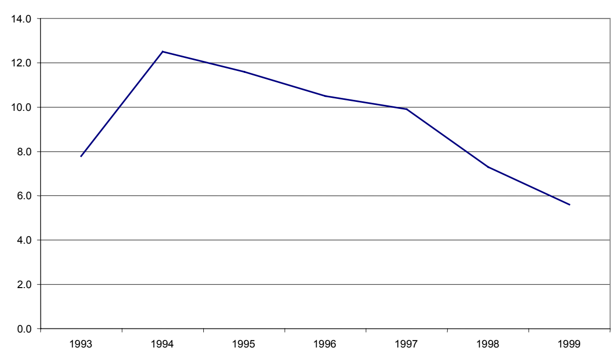


**Figure 3.7: Foreign direct investment (percent of GDP)**

Source: WDI (2001)

In addition, Vietnamese enterprises and banks had borrowed heavily in foreign currency to take advantage of lower interest rates in a steady exchange rate environment. This implied that the devaluation of the VND in August 1998 worsened the situation of both banks and bank customers.

The initial government response to a looming crisis was one of denial. Press coverage on the banking system was restricted following the first signs of problems in early 1997 (i.e.

already prior to the East Asian Financial Crisis). By classifying information relating to the banking sector as state secrets, the government could furthermore penalize anyone who reported on financial sector problems with up to fifteen years in prison.

With the onset of the East Asian Financial Crisis and the resulting popular uprisings and unrest in a number of members of the Association of South East Asian Countries (ASEAN) most notably Indonesia in January 1998, the Vietnamese government shifted from a comprehensive to a gradualist approach to reforms. Instead, priority was accorded to maintaining social and political stability. This implied that the policy response to the crisis included using the banking sector to stabilize and support the crisis-stricken SOEs rather than addressing the inherent and severe problems in the banking sector. The favourable treatment of the SOEs through the SOCBs during 1998 included:

- Abolishing the requirement for SOEs to put up collateral when borrowing from SOCBs
- Permitting lending to loss making SOEs who submit business plans
- Writing off bad loans
- Lower interest rates to SOEs
- Allowing the rescheduling loans to troubled SOEs from 1-3 year terms to 1-5 year terms

The combination of the economic crisis and the SOE support measures put a heavy financial burden on especially the SOCBs, which led to increasing problems during 1998 - 1999. The government response to the possibility of a crisis in the SOCBs did, however, resemble that introducing support the SOEs a year earlier. Thus, the government chose to introduce compensating measures, which to a large extent addressed the symptoms and not the underlying causes of the crisis. These measures included:

- Lowering the income tax rate for the banking system from 45 to 32 percent (January 1999)
- Lowering the reserve requirement ratio from 8 to 5 percent (March 1999)
- Direct allocation of funds (September 1999)

Since data are not available on bank financial performance and the size of their nonperforming loans based on international loan classification and risk management standards, it is difficult to gauge the severity of the problems and the extent to which the above-mentioned measures worked. This is a situation, which is further complicated by the very limited overall transparency in the financial sector and the existence of special rules. For example, NPLs resulting from directed lending and some credit programmes for the poor are not classified as NPLs (KFW 2002). The problems associated with the high ratio of NPLs in the banking sector and the measures proposed to resolve these problems are the subject of Section 5.5.

International observers have noted how the crisis and ensuing widespread social unrest in South East Asia during 1997-98 raised doubts over the continued reform process in the minds of Vietnamese party leaders. Fear of loosing control made the Vietnamese approach towards further reforms piecemeal and cautious. Albeit the need for further comprehensive reforms was stressed in official communiqués from a number of Central Committee plenums, it appears to have been more rhetoric than reality. Consequently, Vietnam did not follow the repeated advice of international agencies (led by the World Bank and IMF) in the years following the EAFC to implement a second round of comprehensive reforms – a 'Doi Moi 2'.

The Ninth Party Congress held in March 2001 marks a turning point with respect to obtaining a commitment towards comprehensive and far-reaching reforms. In preparation for the Ninth Party Congress the government had undertaken a number of strategic planning exercises including the formulation of a Development Strategy for the period 2001-2010 as well as ten-year strategies and five-year plans for key sectors prepared by the responsible line ministries.

Following the Party Congress the government further committed itself to reforms by requesting and obtaining a three-year assistance arrangement with the IMF and the World Bank. This first agreement between Vietnam and the Bretton Woods institutions increased the pressure for early and sustained reforms of both the SOCB and the SOE sectors.

Some have explained the resurgence of an official commitment to comprehensive reforms by the failure to obtain the pre-crisis high economic growth rates in the three years following the EAFC (see Figure 3.1). In 2000 the government undertook a substantial loosening of the credit policy in an effort to boost domestic investments. The majority of the rapid growth in credit was in VND and stemmed from the SOCBs.[10] The expansion of domestic credit, however, failed to produce immediate results, and the

[10] This most likely resulted in a decrease in asset quality, as SOCB lending was not subject to sufficient market discipline.

three-year slow-down in economic growth following the EAFC apparently made it possible to convince conservative reformers in the government that continued reforms coupled with regional and global integration was the only way to regain the performance legitimacy that high growth rates had bestowed upon the government prior to the crisis.

The pace of structural reforms in the banking sector had, however, already begun to slowly pick up in 2000. The first priority was to restructure and strengthen the JSBs. The SBV completed the financial assessment of 48 JSB by the end of 2000, and on the basis of these the SBV completed and approved restructuring plans for all 48 JSBs. The result was that 13 of the 48 JSBs were placed under special supervision/control by the SBV that two licenses were revoked and that one bank merged. The licenses of another set of JSBs were revoked later in 2001, and a number of other JSB will follow suit unless improvements are recorded in the central prudential ratios. In December 2001 the number of JSBs had been reduced with almost 40 percent compared to 2000, and the expectation is that the current number of JSBs will be halved over the next two years (IMF 2001).

The renewed propulsion in the reform process was, however, not restricted to the JSBs. In March 2001 the government approved an overall SOCB reform framework. The objective of this framework is to enforce better lending discipline and the government has announced that policy induced lending will be phased out 'except under limited and explicitly identified circumstances with government guarantees'.[11] The phasing out of policy lending is furthermore made conditional on the establishment of a policy bank, which is envisioned to issue all new policy loans.

Moreover, each of the four large SOCBs will, conditional on satisfactory performance and progress, undergo a phased recapitalisation over the next three years. In this context, satisfactory performance entails undergoing reforms and restructuring in a number of areas. Measures are aimed at increasing the transparency of SOCB operations and include independent audits based on international accounting standards of each bank and ensuring that loan classification and loan-loss provisioning are more in line with international standards. The full adoption of loan provisioning according to international accounting standards will moreover be introduced gradually over the next three years.[12]

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[11] See, Socialist Republic of Vietnam (2001a). It remains to be seen how the government defines 'limited' circumstances.

[12] The structural reforms and the regulation of the financial sector is the subject of Chapter 4, which also contains a comparison with regulatory practice in other ASEAN countries.

The total costs of the banking reform and recapitalisation are still uncertain, but a preliminary estimate (IMF 2001) puts the total capital costs of the banks debt recovery process at VND 24 trillion – amounting to approximately 5 percent of GDP. The government has announced that the cost of banking reform and recapitalisation will be treated as an extraordinary outlay and financed through internal bank resources, including loan recoveries and strengthened profitability, nonnegotiable government bonds, bank bonds, external support and government budgetary resources.

The recent approval and adoption of specific plans for Incombank (ICB), Vietnam Bank for Agriculture and Rural Development (VBARD) and the Bank for Investment and Development (BID) in November 2001 have further served to bring reform efforts back on track.

In addition to the efforts to restructure and recapitalise the SOCBs, the earlier mentioned SOE/SOCB interdependence is directly and indirectly addressed in a number of related financial sector initiatives and policies, including:

- The decision to restrict debt relief in the context of SOCB restructuring to SOEs undergoing government approved reform measures. Loan-reduction and/or write-off can only be applied for SOEs that are subject to liquidation, divestiture, or equitisation under the SOE reform programme.

- A ceiling on bank system credit accorded to individual SOEs, including a special monitoring of bank credit and budget support for 200 SOEs with large debts.

- The medium-term SOE reform plan adopted in March 2001 stipulating annual targets for equitisation, divestiture, and closure over the next three years. The plan includes steps to strengthen SOE financial discipline and introduce safety nets for redundant labour.

- The opening of the official Vietnamese stock exchange in June 2000. Although the initial number of listed companies was only five, the symbolic importance of this event was significant. It presented firms and SOEs with a potential future alternative source of financing.

The government moreover aims to coordinate overall credit policy with the pace of SOE and SOCB reforms, in particular to impose greater financial discipline on the highly indebted SOEs. The overall framework for doing so is improved as the government on the basis of the recent Public Expenditure Review has developed and implemented a programme intended to improve the transparency, tracking and accountability of public spending. In parallel with the efforts to put bank operations on a commercial basis whilst reducing SOCB/SOE interdependence, the overall financial sector framework will undergo a number of structural reforms towards greater reliance on indirect instruments. This includes:

- A more flexible interest rate. In August 2000 a new base rate mechanism was introduced. This entailed widening the allowable range in which banks set lending rates coupled with a further relaxation of controls. In November 2001 the interest rate ceilings on foreign currency loans were abolished, bestowing Vietnamese lenders the opportunity to negotiate for foreign currency loans in both overseas and Vietnamese based banks. The banks based in Vietnam can, however, not necessarily set interest rates on foreign currency loans at their own discretion, as they are required to take international market rates and the domestic supply and demand in account. Lending in VND is still subject to an upper limit on interest rates, which is defined as the base rate plus 0.3 percent for short term loans and plus 0.5 percent for medium to long term loans.

- A more flexible exchange rate. Over the period 1990 –2001 the government gradually eased the control of the exchange rate. Initially, the government had sought to adjust to the changing external environment through adjustments in the official rate and/or the width of the trading band. In February 1999 the SBV, however, announced that the official rate was abolished, and that the government would in the future influence the exchange rate through the inter bank markets only. The foreign balancing requirement for foreign invested companies was lifted in November 2000, and in December 2001 the requirement that companies have to deposit 50 percent of their foreign currency earnings with the banking sector was eased to 40 percent.[13]

Alongside the structural reforms and the gradual liberalization of the banking sector, considerable efforts have been undertaken to strengthen the regulatory and supervisory capacity in Vietnam. The State Bank of Vietnam holds a central position in these efforts.

Summing up the second phase (1997 – the present) can be characterized as a gradual return to the more comprehensive and fundamental reforms of the financial sector that were discarded following the East Asian Financial Crisis in the 1997 – 1998. It is, however, important to note that most of the more fundamental reforms are still at an initial stage, implying that the official commitment and resolve towards reforms has yet

[13] The plan is to gradually phase out this rule over the next three years.

to be seriously tested. In this context a very important litmus test of the political will to sustain the efforts to introduce a more market-based financial sector will be the above-mentioned efforts to restructure and recapitalise the SOCBs and their NPLs in particular.

## 3.3 Concluding Remarks

The identification of two distinct phases in the transition from a government controlled financial sector towards a more market-based system does not exclude the possibility that structural events originating in the first phase continue to exert considerable influence – even today. In this context, two events from the first phase stand out:

- The virtual collapse and ensuing disappearance of the credit cooperative system during the last half of 1990 may have had detrimental effects upon the general level of trust in the formal financial system – even today.
- The decision to liberalize the financial sector as one of the first sectors prior to both any attempts at liberalizing the SOE sector and a decision to limit/stop directed lending is likely to have contributed greatly to the magnitude of the NPL problems, which are at the heart of the matter of the problems facing the financial sector today.

Alongside with the above-mentioned effects of the East Asian Financial Crisis on the overall government approach to further reforms and liberalization, it should be clear that the historical analysis performed here can contribute significantly to the current understanding of the issues and problems in the sector.

Finally, the following timeline summarises important events in and relevant to the Vietnamese financial sector:

**1990**

- A large number of credit cooperatives go bankrupt causing the virtual collapse of the credit cooperative system.
- The SBV and the two-tier banking system are established.
- The Rules governing new entries into the banking system are liberalized.
- The Rules on the stipulated sector specialization of the four major

SOCBs are removed.

**1991**
- The practice of increasing money supply to finance budget deficits is officially abolished.

**1992**
- Tight fiscal and monetary measures cause the rate of inflation to decrease and real interest rates to turn positive.

**1993**
- The domestic inter-bank market is established.
- All forms of subsidized credit to SOEs are officially terminated.

**1994**
- The inter-bank market for foreign currency is established.
- The Bankruptcy Law governing all enterprises is passed and economic courts to hear such cases are established.
- Vietnam joins the ASEAN.

**1995**
- Civil code passed by the National Assembly requires the SBV to clarify rules governing borrowing and lending to commercial banks.

**1996**
- The property market in Hanoi and Ho Chi Minh City collapses.
- SBV issues a loan classification system stipulating the grouping of loans into four categories.

**1997**
- 6 percent devaluation to the US dollar (February).
- East Asian Financial Crisis results in macroeconomic turmoil and crisis throughout the region, leading to considerable devaluation of currencies in and reductions the growth rates of neighbouring

countries.

- 10 percent devaluation to the US dollar (August).

**1998**

- The Law on the State Bank comes into effect, stipulating the degree of SBV independence.
- The National Congress ceases to officially influence interest rate levels.
- Commercial banks are required to make provision for loan losses.
- State Bank recapitalisation improves the capital adequacy of the SOCBs.
- A number of JSBs come under special control/supervision. Some have their licenses revoked, while others are forced to merge with other JSBs.

**1999**

- Independent diagnostic audit of the SBV, the SOCBs and the JSBs were completed.
- On the basis of these audits, the government decided to restructure the JSBs first. JSBs were classified into four types and restructuring strategies for each type were developed.
- Bank Restructuring Committee is established.
- Postal savings system is established.

**2000**

- National stock exchange opens in Ho Chi Minh City.
- Exchange rate policy and regime is eased.
- Land use rights and other fixed assets are permitted to be used as loan collateral
- Using the inter-bank market the SBV initiates more market-based

control of end-customer interest rates in the banking sector.

- Vietnam - United States bilateral trade agreement is signed.
- Interest rate controls on foreign currency deposits are liberalised.
- Foreign balancing requirement for foreign-invested enterprises is lifted.
- The Law on Insurance Business is passed.

**2001**

- Medium-term SOE reform plan adopted (March). Banking and SOE reform is given priority. Total estimated costs of banking and SOE reform (2001-2003) between 7-12 percent of GDP (depending on accounting standards used).
- IMF initiates the recapitalisation of the four large SOCBs.
- Decision 284 officially brings loan classification and loan-loss provisioning in line with international standards.

**2002**

- A decentralised system of asset management companies is established to face the problem of non-performing loans in the SOCBs.
- Phased recapitalisation of the SOCBs is initiated on the basis on comprehensive reviews based on international accounting standards. The process is, however, off to a slow start.
- Banks are allowed to set interest rates for loans through individual assessment of and negotiations with individual customers.

# 4 Bank Supervision and Regulation

The question of whether financial development leads or follows economic growth has been addressed in a number of both empirical and theoretical analyses. A significant body of the literature has suggested that financial development can contribute significantly to economic growth. Nevertheless, the question remains as to how exactly this takes place and what governments can do to support and strengthen the growth enhancing functions of the financial sector.

Although the predominantly negative experiences from the use of directed credit and controlled interest rate levels during the 1970s and 1980s to some degree continues to discredit direct government controlled credit allocation, it is increasingly recognized that government failure does not imply market success. This is especially the case in the financial sector, where moral hazard and adverse selection problems are both abundant and a particular concern given the fact that most transactions are forward-looking and based on mutual trust in the other party's ability to honour the specified contracts. Hence, government intervention in and regulation of the financial sector is justifiable, but in what form and to what degree? Should the government aim at achieving a certain level of financial depth or the implementation of a certain structure, or should the government focus more on the establishing an optimal framework guiding the financial sector while letting market participants choose the direction and speed of change?

Recent research, using country-, industry-, and firm-level investigations of the financial structure for economic development, has shown that distinguishing countries by financial structure does not help explain cross-country differences in long-run GDP growth, industrial performance, new firm formation, firm use of external funds, or firm growth (World Bank 2002, and Beck, Demirgüc-Kunt, Levine and Maksimov 2000). Taken at face value, this implies that policymakers should concentrate on strengthening the legal and regulatory framework rather than attempt to build a particular financial structure. It could moreover imply that a government's success in designing and implementing an effective legal and regulatory environment to support the natural evolution of a given financial structure has a positive and important effect upon the country's ability to compete with other countries.

If one accepts the above-mentioned perspective as a working-hypothesis it becomes very interesting to compare Vietnam's effort and performance in the area of financial sector regulation with that of other ASEAN economies. In this context, the objective of a regional comparison is to assist in the analysis of whether and from whom Vietnam could learn how to create a regulatory and legal framework that is more conducive to financial sector development and economic growth.

The analysis will be performed in seven separate subsections. Following a brief introduction to the history of financial sector regulation in Vietnam in Section 4.1, we turn to analysing the degree to which the regulatory framework in Vietnam is affected by historical determinants in Section 4.2. Subsequently, in Section 4.3 the analysis moves on to consider how competitive the Vietnamese financial sector is compared to other countries in the region and to developing countries in general. In this context, privatisation and entry requirements are considered as key examples of policies that can be used to generate a more intensive competition between financial sector institutions. Section 4.4 analyses the regulatory framework, which is compared to that of other countries in the region and to developing countries in general, while Section 4.5 compares Vietnamese accounting and auditing standards with those of the other countries in the region. The issues of safety nets, capital adequacy and deposit insurances are considered in Section 4.6, which precedes the interim summing-up and conclusion in the final Section 4.7 of this chapter.

## 4.1 Retrospective

Bank regulation and supervision has existed in some form or other in Vietnam since the creation of the State Bank of Vietnam (SBV) in 1951 (see Chapter 5), where the Office of State Inspection audited the activities of the SBV. The creation of a two tier banking system in 1989 and the continuing transition to a market economy imposed new challenges that required changes in the objectives, structure, and implementation of the prudential supervisory framework. One of the most important and difficult changes is the effort to create a more level playing field between government and privately controlled financial institutions.

Like many other developing countries Vietnam has a concentrated banking sector with a high level of state ownership. Following the Asian Development Bank (ADB 1999), the major State Owned Commercial Banks (SOCBs) hold approximately 75 percent of total assets of the banking sector. In addition, the SOCBs are large shareholders in the Joint Stock Banks (JSBs), and as markets for SOCBs and JSBs are completely separate in terms of both depositors and borrowers the share of assets under complete or partial government control could be much higher. The SOCB dominance is further reflected in the fact that the major SOCBs undertook approximately 80 percent of the commercial bank operations during the 1990s although this share was declining somewhat during the period (see Chapter 6).

Given their dominant and central position in the financial system, the SBV continually exerts considerable efforts to strengthen the legal and regulatory framework for the SOCB. Recently, new regulations where adopted to strengthen the prudential framework. This most likely reflects that the SBV and the government have realized the importance of the implementation of an effective prudential bank supervision programme. The changes are far-reaching and affect the financial sector in a multitude of ways – all pointing towards a gradually larger reliance on guided market powers. The recent reforms include:

- Strengthening the legal and regulatory framework for entry and exit into the sector. Here the plans for the near future include a standard review of minimum capital requirements, the introduction of qualitative evaluations of new entrants, and the creation of accountability standards for Bank Board of Directors and senior management.

- Addressing potential conflicts of interest and moral hazard problems. Vietnam has, in order to reduce the risk of encountering problems of this nature, adopted regulation that limits financial institutions from lending to shareholders, directors and enterprises in which the bank has ownership interests. In addition, Vietnam has agreed to establish and implement a risk based bank supervision system and is currently working on the development and establishment of a CAMEL[14] bank rating system, which is required if a risk-based banking supervision is to result in improved bank supervisory practices.

- Protection of depositors. A deposit-insurance scheme covering all depositors has been established.

- Enhancing the overall transparency of the sector. As a part of the agreement with the IMF and the WB the Vietnamese government has pledged to change the current loan classification and the loan loss provisioning standards to bring them in line with international standards. As a part of this process independent IAS audits of the large SOCBs was recently completed – although the results have not been made publicly available. Finally, the government has indicated that bank

[14] CAMEL is an internationally recognized framework for assessing the **C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity of banks. Recently, an '**S**' for **S**upervision was added, making the acronym CAMELS.

compliance to the revised loan classification and loan loss provisioning will be verified through recurrent audits. In addition, the government is considering whether or not it should develop an implementation plan for the use of IAS in the banking sector and in banking supervisory functions.

Some of these recent reforms should be viewed in connection with the efforts to restructure the four large SOCBs. This restructuring is among the current big issues in the efforts to develop a transparent and accountable financial sector, and in some areas they have already begun. The government has, for example, already developed and agreed upon a detailed restructuring plan for the Vietcombank. This consists among other things also of a timetable for the implementation of performance conditions closely linked to its phased re-capitalization over three years. During the next couple of years a detailed restructuring plan for the Vietnam Bank for Agriculture and Rural Development (VBARD), Incombank and the Bank for Investment and Development of Vietnam (BIDV) will be developed on the basis of the recently completed IAS audits mentioned above. In this context the issue of the non-performing loans held by the SOCBs play a crucial role. Due to its central importance for the overall stability and profitability of the financial sector the issue of NPL is analysed in depth in Section 5.5.

Overall, the reform strategy for the banking sector in Vietnam aims at restoring soundness to the system and to improve the efficiency of financial intermediation. As described throughout this report, the Vietnamese government has adopted a wide range of reforms designed to increase competition, move toward a market-oriented allocation and mobilization of resources while maintaining system stability. Although the above-mentioned reforms in many ways represent steps in the right direction, this process of gradually liberalizing the financial sector is not without risks for both the financial sector and for the economy as a whole. The cost of re-capitalization of the SOCBs might, for example, give rise to concern if the pace of SOE and banking reform slows down.

Many of the above-mentioned reforms are inspired by the experiences of other countries and/or internationally recognised best practice. In this context it is, however, important to recognise and take into account that Vietnam's initial conditions (see below) for a sound financial development might be quite different from the countries with which Vietnam normally compares herself. Furthermore, it is important to note that the financial sector in a developed country differs significantly from that in emerging market economies. As a result, "best practice" lessons from developed countries do not always translate to developing countries such as Vietnam.

## 4.2 Law, Politics or Endowments

A recent World Bank study (Beck, Demirgüz-Kunt and Levine 2001) evaluates different theories of why some countries develop well-functioning financial systems, and why some countries have laws that support financial development. Three theories/views on the historical determinants of financial development are assessed here:

1. The legal view, which emphasizes legal traditions as a central prerequisite for sound and stable financial sector development.

2. The political view rejects the central role of the legal tradition and stresses instead the central influence of politics on financial sector development.

3. The endowment view puts emphasis on the fact that geography and climate induced disease proneness influence the formation of economic and political institutions, which again influence financial sector development.

Turning first to the legal view, one can identify two primary channels through which legal tradition influences financial development: (a) legal traditions differ in terms of the priority they attach to private property rights and investor rights, and (b) the protection of these rights form the basis of financial contracting (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1998 and 1999). If correct, one implication of this view is that historically determined differences in legal tradition can help in explaining observed cross-country differences in financial development. According to the legal view, legal traditions are spread throughout the world through conquest, colonization, and imitation. Furthermore, once systems and institutions are in place, they are difficult to change and/or change very slowly, the implication being that a significant proportion of current international differences in financial development can be traced back to different historical origins and traditions dating back to the colonial era in less-developed countries.

Table 4.1 contains a listing of the legal origin of some of the South East Asian countries, revealing that Vietnam and Cambodia are the only countries, which share a legal environment, which is influenced by both the Socialist and French legal tradition. One of the main results in La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998, 1999) is that the legal systems in countries, which follow a French civil law tradition, appear to be less effective in supporting financial development than legal systems in countries, which adhere to a German, British or Scandinavian legal tradition/system. Hence, La Porta et al. establish that countries with a German or a British legal tradition in general have achieved a higher level of greater financial development than countries where the legal system adhere to a French legal tradition. The explanations given by the La Porta et al. is that French civil law is more static than other legal traditions, which in combination with a more widespread distrust of judges, a distaste for jurisprudence and for open judicial disputations, make the French legal tradition more comfortable with rigid bright-line rules and legal certainty. The result is that a legal system, which follows the French tradition typically, is less responsive towards sectors and conditions that change frequently (as is typically the case in the financial sector). In short, the financial sector will typically not be facing a sufficiently high level of judicial discretion in countries where the legal system follows the French tradition, which in turn have a detrimental effect upon financial sector development.

If one believes that legal origin matters to the degree proposed by (among others) La Porta et al., the policy implications are quite clear. While Vietnam cannot change its legal origin, it can – albeit with considerable effort – reform its judicial system by emphasizing the rights of outside investors, by making contract enforcement more efficient, and by creating a legal system that more effectively evolves to support changing economic conditions. Another point, which is worth emphasizing, is that Vietnam should be careful about making direct inferences and/or adopting Chinese financial development policies without prior modifications and adaptation according to a Vietnamese context. The reason is the different starting point with regard to legal origin. The policies necessary in order to secure sound financial development in Vietnam may be much more fundamental and far-reaching than those implemented in China.

Turning next to the so-called "political view" of financial development, this theory predicts that political factors will dominate the legal factors in determining the level and/or pace of financial sector development. These theories are inspired by North (1990) and Olson (1993) and emphasize that the elite will pursue their own interests, which in turn are reflected in government policies. Furthermore the proponents of the political view stress that political structures inherently tend to thwart financial development. For example, it can be argued that a centralized and powerful government tends to be incompatible with financial development, because the proper functioning of financial institutions and markets requires imposing limitations on government discretion, which might again be incompatible with the ambitions of a centralized and powerful state. Only if the elite sees itself as being enriched by free, competitive markets, will this group exert pressure on the state to create laws and institutions to stimulate financial development.

The Legislative and Executive Index of Political Competitiveness (LEIPC), which is depicted in Table 4.1, indicates that according to the politics view one might predict difficulties in developing a sound and well-functioning financial system in Vietnam, China and Indonesia. However, Beck, Demirgüz-Kunt and Levine (2001) show that the measures of the initial and current political structure do not explain cross-country variation in financial development. Thus, the data are not consistent with the emphasis of the politics view on political structure shaping financial development, which is why the focus on the LEIPC for financial development in the context of Vietnam should not be over-emphasized.

**Table 4.1: Legal origin, political system and initial endowments**

| | Legal origin | Legislative and executive index of political competitiveness (LEIPC) [a] | Latitude (mean = 0.26) | Tropical climate (mean = 0.60) | Log settler mortality (mean = 4.66) |
|---|---|---|---|---|---|
| Vietnam | French/Socialist | 8 | 0.18 | Yes (1) | 4.94 |
| Cambodia | French/Socialist | 12 | 0.14 | Yes (1) | n.a. |
| China | German/Socialist | 6 | 0.39 | No (0) | n.a. |
| Indonesia | French | 8 | 0.06 | Yes (1) | 5.14 |
| Korea | German | 14 | 0.41 | No (0) | n.a. |
| Malaysia | British | 14 | 0.03 | Yes (1) | 2.89 |
| Philippines | French | 14 | 0.14 | Yes (1) | n.a. |
| Thailand | British | 14 | 0.17 | Yes (1) | n.a. |

Source: La Porta et al. (1998, 1999), Beck, Demirgüz-Kunt and Levine (2001), Database of Political Institutions (DPI) see Beck, Clarke, Groff, Keefer and Walsh (2000), Acemoglu et al (2001), Global Development Network Database (See http://www.worldbank.org/research/growth/

Note: n.a. means not available.

[a]The scores according to the Legislative and Executive Index of Political Competitiveness range from 2 - 14, where a score of 2 indicates a non-competitive political environment and a score of 14 indicates the most competitive political system. The index is documented for the year 1997.

Finally the "endowment view" argues that differences in geography and disease proneness have shaped patterns of the political, institutional, and economic development. Gallup, Sachs, and Millinger (1998) find that geographical position influences the types of diseases that exist, the organization of economic activity, and hence the formation of institutions, political arrangements, and the level and pace of economic development. According to this line of research, areas with poor agriculture and areas that are geographically isolated cannot exploit economies of scale in agriculture. In addition, countries dominated by 'poor' climate have a correspondingly lower probability of developing the political, legal, and institutional foundations that support complex and specialized economic interactions, which again help to create long-run economic growth.

The endowment view therefore predicts that countries in poor geographical and disease environments will have less well-developed financial institutions than countries with better initial endowments. Acemoglu, Johnson, and Robinson (2001) focus on the disease environment, and argue that the initial disease environment was decisive in whether colonialists created a "settler" or an "extractive" colony, which is found to have an enduring influence on financial institutions today. If the colonialists encountered a hostile (i.e. high mortality setting) they would choose to develop institutions that were extractive – i.e. designed to capture an already existing surplus for the colonial power. If, on the other hand, the environment was not too hostile to the first settlers (i.e. a low mortality setting) the colonial powers would choose to create institutions that could further develop the country for the benefit of the colonial power. Hence, the early environment faced by the first settlers is likely to have had decisive influence upon the type of institutions and modes of operation left by the colonial powers. If one furthermore believes that formal and informal institutional development and change only occur very slowly and with great effort, the colonial heritage is likely to still have an influence on current institutions and practices. Thus, according to the endowment view, the initial conditions continue to exert a profound influence on the present day financial sector. Consequently, a better knowledge of these factors will assist in predicting whether or not countries in poor geographical and disease environments have less well-developed financial institutions.

Looking again at Table 4.1, three indicators of initial endowments are listed. The first two, latitude of the capital in the respective countries and the World Bank classification of whether or not a country has a tropical climate, indicate that Vietnam from an endowment point of view is no worse off than the rest of the region. Only China and Korea are considered not to have a tropical climate. In addition, the latitude of their respective capitals is the highest among the countries considered here. Looking at the third indicator, settler mortality, taken from Acemoglu, Johnson, and Robinson (2001), it indicates that Vietnam does not deviate much from the sample mean, with a reported average annual total of 140 casualties among every 1000 soldiers.[15] Hence, there is nothing that indicates that Vietnam should be worse off than any other country in the South East Asian region when it comes to institutional determinants and structure when evaluated from an endowments point of view.

Beck, Demirgüz-Kunt and Levine (2001) evaluate all three theories as to their power to explain the level of financial development. The results appear to be most in line with the "legal view" as differences in legal origin continue to help explain the development of financial institutions today, even after controlling for the level of economic development, geographical endowments, religious diversity, ethnic diversity, openness to international trade, number of years the country has been independent since 1776, transplant effect, initial endowments, political environment, and the power of the central government over the judiciary branches of the government. With this result in mind it would appear the legal origin represents a key challenge in the ongoing efforts to reform and develop the Vietnamese financial sector.

## 4.3 Bank Competition, Privatisation and Foreign Bank Entry

Over the last decade or so the perception of the potential benefits arising from increased competition on financial markets has become more diverse and more nuanced among economists and financial sector specialists. On the one side, some view competition between financial institutions as having universally beneficial effects upon financial sector efficiency regardless of its level of intensity. In addition, increased competition is perceived to have beneficial effects on the size of the consumer surplus and on the overall soundness of the financial system. On the other side, one can also find economists who, although they recognize the potentially beneficial effects of increased competition, also warn of the potentially destabilizing factors, which may arise if competition becomes 'too' intense. One of the potentially destabilizing effects identified by this latter group is the notion that very intense competition between banks can undermine the franchise value of individual branch offices or even entire banks, possibly leading them to engage in more risky investments in an attempt to gamble for resurrection. This could in the worst case destabilize the entire system making it vulnerable to financial crises, which

[15] The standard measure is annualized deaths per thousand soldiers with each death replaced with a new soldier.

might lead to real losses that outstrip the initial beneficial effects of increased competition.

One consequence of the above-mentioned dissenting views over the potential net effects of increased competition is that one cannot claim that policy makers should always and uncritically attempt to increase competition in the financial sector. Excessive competition may create an unstable banking environment, while insufficient competition may breed in inefficient or reduced credit access for borrowers. Thus, instead of relying on generalizations and a dogmatic approach, policy analysts should instead carefully consider both short-term and long-term effects of policies aimed at increasing financial sector competition.

However, despite adopting this more critical approach to the potentially beneficial effects of competition, one cannot but conclude that the degree of financial sector competition has to be increased in Vietnam. This in turn raises the question whether or not the government should seek to regulate/limit entry to and competition within the sector. Adopting a theoretical perspective, one can identify the following potentially beneficial effects from restricting entry and competition within the financial sector:

- Banks with monopolistic power have stronger incentives to incur the necessary costs associated with overcoming informational barriers. In addition, monopolist banks have a high franchise value, which will enhance prudent risk-taking behaviour. Hence, the government may gain from limiting the potentially destabilizing competition within the sector.

- Government ownership of banks may facilitate the mobilization of savings as well as the allocation of those savings toward strategic projects with long-term beneficial effects on an economy. The former is due to the often-higher credibility of the government, while the latter can be attributed to the government having adequate information and sufficient incentives to ensure socially desirable investments.

- Regulators may need to limit entry in accordance with the ability of official agencies to supervise banks. Monitoring banks is costly and associated with externalities giving room for free rider problems.

- A high concentration of private ownership in the banking sector may lead to limited access to credit by many parts of the society, which could negatively affect economic development.

- As has been illustrated by the East Asian Financial Crisis bank failures can reverberate throughout an economy with devastating effects. By effectively screening bank entry, governments can promote bank stability.

One can, on the other hand, turn to, for example, corruption theory to identify the following theoretical arguments against the government seeking to limit/dampen competition in the financial sector in developing countries:

- Politicians and regulators may misuse entry restrictions to reward friendly constituents and collect bribes, i.e. regulating bank entry may enhance corruption and economic inefficiency.
- Competitive banking may be less likely to produce powerful institutions that unduly influence policymakers in ways that adversely affect bank performance and stability.
- Governments have neither sufficient incentives to ensure socially desirable investments nor the information to do so if they wanted.
- Government ownership tends to politicise the resource allocation and often operate with soft budget constraints, which are likely to have detrimental effects on economic efficiency.

Returning to the current low level of financial sector competition in Vietnam and adopting a legal perspective, it is possible to identify at least three reasons for the current low level degree of competition:

- Although many of the privileges and sector orientation has been lifted from the SOCB, each SOCB still tries to maintain its specialization towards specific sectors or customers. The result is highly segmented financial markets characterised by a low degree of competition between the different types of formal financial institutions (see Section 6.3.2 for an analysis of this problem in the context of the agricultural sector).
- Even the seemingly stronger competition among the JSBs is restricted by regulation to include only interest rate competition.
- Competition between domestic and foreign banks has for a long period of time been blocked by restrictive legislation. Foreign banks are, for example, only allowed to mobilize 25 percent of their capital in VND. Just recently the legal framework was, however, improved as all banks (including foreign bank

branches) in Vietnam may now accept land-use-rights as collateral. This represents a vast improvement over the situation during the 1990s where regulation explicitly prohibited foreign banks from accepting land-use-rights as collateral. In addition, the latest streamlining of the banking operation procedures imply that foreign banks are now allowed to open branches and to establish joint ventures in Vietnam – also an improvement over previous practices (see Section 6.2.2.2. for further examples of problems of this nature)

The above-mentioned legislation indicates that the Vietnamese financial system is characterized by low competition, but how can one go about comparing the degree of competition in Vietnam with that of other ASEAN countries? One approach, which builds upon the conventional economic wisdom that an increase in the number of competitors results in an increase in the degree competition, is to compare market concentration indices for the respective countries. One could also compare the fraction of foreign ownership in the sector. This latter approach builds upon an assumption of foreign owned banks being less susceptible to influence by the domestic government, and perhaps relatively more interested in maximizing profits.

Table 4.2 and 4.3 list some market structure indicators for Vietnam and other ASEAN countries. Contrary to what one may believe, it can be seen that bank concentration in Vietnam, measured as the fraction of deposits held by the five largest banks, is not higher than in, for example, Thailand. Furthermore Table 4.3 indicates that the banking sector in Vietnam is less concentrated than that of the average developing country.

One aspect, which, however, stands out in both tables, is the degree of government ownership in the Vietnamese banking sector. The degree of government ownership of financial institutions in Vietnam is very high compared to both the other countries in the region and to the average level in developing countries.

This should be viewed in the context of the recent evidence from cross-country analyses (Laporta, Lopez-de-Silanes and Schleifer 2002, and Barth, Caprio and Levine 2001a) indicating that a higher degree of state ownership of banks tends to be associated with lower bank efficiency, less saving and borrowing, lower productivity and slower growth. Furthermore there is no evidence that state ownership lowers the probability of banking crisis. Generally the negative effects of state ownership appear to be more severe in developing countries than in industrialized countries.

| **Table 4.2: Market structure indicators in South East Asia (percent)** | | | |
|---|---|---|---|
| | Bank concentration (share of deposits held by five largest banks) | Share of deposits of the five largest banks, which is held by foreign owned banks | Share of the deposits of the five largest banks, which is held by government owned banks |
| Vietnam | 65 | 0 | 80 |
| Cambodia | 67 | 71 | 16 |
| China | 75 | n.a. | n.a. |
| Indonesia | 53 | 7 | 44 |
| Korea | 48 | 0 | 30 |
| Malaysia | 30 | 18 | 0 |
| The Philippines | 46 | 13 | 12 |
| Thailand | 75 | 7 | 31 |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

Note: n.a. means not available.

Note: '0' indicates that none of the foreign are among the five largest banks in Vietnam – see Section 6.1.3 for an estimate of the share of total deposits held by foreign banks.

| **Table 4.3: Market structure indicators in a global perspective (percent)** | | | |
|---|---|---|---|
| | Bank concentration (share of deposits held by five largest banks) | Share of deposits of the five largest banks, which is held by foreign owned banks | Share of the deposits of the five largest banks, which is held by government owned banks |
| Vietnam | 65 | 0 | 80 |
| Developed countries | 61 | 25 | 36 |
| Developing countries | 71 | 10 | 22 |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

As for the benefits and costs associated with liberalising entry into the financial sector, the results of Barth, Caprio and Levine (2001a) analysing banking sector performance in 107 countries indicate that tighter restrictions on entry into banking tend to increase overhead costs. Barth et al. are, however, not able to find a link between bank performance and the actual level of bank concentration. Furthermore, they find that the likelihood of a major banking crisis is positively associated with greater limitations on foreign bank participation, a result which may be worthwhile to consider before thinking about the policy recommendations for Vietnams future financial development. Moreover government ownership is found to be generally positively related to the level of non-performing loans (NPLs) in an economy but not robustly linked with the other performance indicators.

Although bank concentration is often used as a proxy for the level of competition in the sector, it is still difficult to generalize about the precise effects of concentration. A high level of concentration does not need to reduce competition, as concentrated systems can be competitive if they are contestable. This implies that potential-entry forces market participants to keep rents low in order to avoid an intensification of the competition in the sector. For this reason, one should complement the concentration measures cited above with measures of entry and exit restrictions. The underlying rationale is that tight restrictions on entry into the banking sector can create monopolies/duopolies that are associated with higher average interest rate margins and overhead expenditures. Additional restrictions on foreign entrants can be associated with lower sector portfolio quality and greater likelihood of a banking crisis.

Table 4.4 depicts some competition regulatory variables for Vietnam and the East Asian region. The data for Vietnam are unfortunately incomplete. It was not possible to obtain information about both the number of applications and the number of rejections hereof. The table does, however, also hold the results of a survey of whether or not special legal permissions are required to obtain a license to operate a bank in the respective countries. Results of this survey are reported as an index ranging from 0 to 8 where higher values indicate a more restrictive system. Hence, higher scores imply that one would expect that entry into the banking sector was more restricted and/or deterred, partly because there are more grounds for rejecting a license request and partly because potential applicants know this and therefore renege from applying. Looking at Table 4.4 one can note a number of aspects of entry regulation in the East Asian banking sectors, including:

1. Limitations to foreign bank entry exist throughout the region as a significant proportion of both foreign and domestic applications are rejected - the only exceptions are China and to some degree The Philippines. The fact that several countries report that there have been no applications could be due to potential applicants perceiving the sector to be unprofitable or to potential applicants reneging from applying because they perceive it to be futile. The former by implication means that all potential applicants perceive the respective banking sectors to be either so competitive that obtainable rents are too low to justify entry

or that they foresee that they will be discriminated in and/or after their application.

2. Looking at the index on the entry requirements for entry into the banking sector, it can be noted that Vietnam has very restrictive entry conditions. One can moreover see that Vietnam in this respect does not differ greatly from the rest of the region as Thailand and Cambodia are also found to have highly restrictive entry requirements. As mentioned in the beginning of this chapter Vietnam has levelled the playing field for new entrants somewhat. Looking at the above-mentioned index for entry into banking requirements, one can, however, conclude that there is still much to be done before the Vietnamese banking environment can be characterized as competitive or even partly competitive for that matter.

**Table 4.4: Competition regulatory variables in South East Asia**

| | Entry into banking requirement (0-8) | Share of entry applications denied (percent) | Share of domestic applications denied (percent) | Share of foreign applications denied (percent) |
|---|---|---|---|---|
| Vietnam | 8 | n.a.[a] | n.a. | n.a. |
| Cambodia | 8 | 67 | 70 | 67 |
| China | 6 | 25 | 25 | No applications |
| Indonesia | 7 | 60 | No applications | 60 |
| Korea | 7 | No applications | No applications | No applications |
| Malaysia | 7 | No applications | No applications | No applications |
| The Philippines | 7 | 34 | 0 | 43 |
| Thailand | 8 | 100 | 100 | No applications |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

Note: n.a. means not available.

[a] Despite repeated attempts, we have not been able to achieve information on the composition and fate of financial sector entry applications in Vietnam.

Turning to Table 4.5 it can be seen that entry into banking is not generally more restricted in developing countries than in developed countries. However, it appears that the fraction of entry denials is significantly higher in developing countries than in developed countries. A difference, which can perhaps be explained by a higher divergence between de jure and de facto regulation in developing countries, a lower average quality of banking sector applicants in developing countries, or a combination of both.

**Table 4.5: Competition regulatory variables in a global perspective**

| | Entry into banking requirement (0-8) | Share of entry applications denied (percent) | Share of domestic applications denied (percent) | Share of foreign applications denied (percent) |
|---|---|---|---|---|
| Vietnam | 8 | n.a. | n.a. | n.a. |
| Developed countries | 7.19 | 3 | 3 | 2 |
| Developing countries | 7.38 | 31 | 28 | 29 |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

Note: n.a. means not available.

As the evidence cited above indicates that banking sectors in Vietnam and other developing countries can be characterised by a high level of concentration and a lack of competition, liberalizing entry policies appears to offer potential benefits. Cross-country evidence (Claessens, Demirgüc-Kunt and Huizinga 2001) shows that the presence of foreign banks improves sector efficiency by creating competitive pressures that stimulate innovations and improves financial services. The nature and degree of these efficiency improvements will, however, depend on the market that is entered and on the type of entrant.

However, the increased entry of foreign bank could also cause the following problems to occur:

- Foreign banks may facilitate flows of international capital that can be suddenly withdrawn from these markets. Given the magnitude and speed at which international portfolio investment flows can change (the East Asian Financial Crisis is an ever present testimony to this fact) this could easily lead to problems of liquidity and the possible collapse of the domestic financial system. This should, however, be contrasted with the available empirical evidence, which indicates that foreign bank presence actually reduces the probability of systematic crisis in the banking sector (World Bank 2002). One possible channel of influence in this direction is given by the fact that the arrival of reputable foreign banks is generally associated with an improvement in prudential regulations. This could be because foreign banks bring better accounting and information disclosure standards, since they adhere to their home country regulations.

- Foreign owned banks may also overwhelm the capabilities of domestic regulators. This is especially a problem if the home countries of the foreign banks have a low supervisory and regulatory capacity.
- In addition, concerns have been raised concerning the idea that the entry of foreign banks may be associated with less finance for the more disadvantaged segments of the economy, including smaller firms. Because of information problems foreign banks might have a tendency to reduce SME access to finance. However increased competition from foreign banks may force domestic local banks (with private information) into new markets, where they might enjoy a comparative advantage. SME lending could therefore be increased due to the increased foreign competition.
- Another concern is that rapid foreign entry could erode the franchise values of domestic banks and therefore destabilize the financial sector as the troubled banks either close or begin to gamble for their resurrection.

Due to the above-mentioned potential risks associated with foreign bank entry, introducing foreign competitors may require an initial transition period, to allow time for efficiency adjustments in the domestic sector and for improvements in prudential regulation and supervision. In addition, existing restrictions should not be lifted so rapidly that the franchise values of the incumbent banks are endangered or wiped out. The entry process must therefore be both managed over time and transparent. One way of making such a timetable more binding is to put it into domestic laws and/or international agreements. Similarly, because bank failures almost inevitably will occur during this process, the government needs to establish transparent rules for bank exit.

Given that these precautionary measures and policies are in place, the main conclusion would be that the net effect of liberalising the entry requirements for foreign banks in Vietnam would be positive. This is in part based on the conclusion that local banks typically will have high overhead cost and low profitability relative to entrants, and the assessment that the foreign banks by concentrating on large, export-based enterprises and through the acquisition of local banks will be able to overcome any informational disadvantages they may have in lending and/or the ability to raise funds locally.

## 4.4 Supervising and Regulating Banking Sector Activities

In order to be able to compare the supervisory environment in Vietnam with that of other countries in the region and with developed countries in general Tables 4.4 and 4.5 list some official supervisory variables. These variables are thought of as capturing quantitatively the degree to which supervisory authorities in Vietnam are capable of designing and implementing interventions with the objective of promoting a well functioning banking industry. The variable Official Supervisory Power shows that judging by the statues and legislation in place, the power of the supervisory authorities is as good in Vietnam and other developing countries as in developed countries. The extent to which the powers stipulated in the legislation translates into actual powers of implementation is addressed in depth in Section 5.2, which contains an in depth analysis of this issue.

Returning to Table 4.6 we look at the power of supervisory authorities to restructure and reorganize banks and declare a troubled bank insolvent. Here it is found that the Vietnamese authorities are on average bestowed with greater powers than that of other developing countries.[16] However, when we turn to compare the Prompt Corrective Power Index (PCPI), which measures whether or not the law establishes predetermined levels of bank solvency deterioration that force automatic actions, such as intervention, it can be seen that the promptness by which the regulator can or will respond to problems in the financial sector is lower in Vietnam than in most other countries in the region.[17] This indicates problems from the supervisor's point of view to respond to changes in the banking environment quickly enough.

Finally, Table 4.6 and 4.7 show that the supervisory authorities have no or low independence from Vietnamese officials (see Section 5.2 for details on this issue), and this is no different from the situation in the other countries in the South East Asian region. However, Barth, Caprio and Levine (2001a) have shown in a cross-country analysis that there is no clear-cut relationship between supervisory independence and bank development or between supervisory independence and the level of financial efficiency or the level of NPLs. On this background, it is not certain that a more independent supervisory authority will be beneficial for the Vietnamese banking system.

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[16] It is analyzed whether the supervisory authorities have the power to restructure, reorganize and declare insolvency of a bank. The Restructuring Power Index rates between 0 and 3, and the Insolvency Power Index rates between 0 and 2, with higher values indicating greater power.

[17] The Prompt Corrective Power Index rates between 0 and 6, with higher values indicating more promptness.

Whether or not the creation of an independent supervisory institution is beneficial for the SBV attempts to obtain more independence is the subject of Section 5.4.

**Table 4.6: Official supervisory variables in South East Asia**

| | Supervisors per bank | Official supervisory power index[18] | Prompt corrective power index | Restructuring power index | Insolvency Power Index | Independence of supervisory authority |
|---|---|---|---|---|---|---|
| Vietnam | 3 | 11 | 0 | 3 | 2 | No |
| Cambodia | 0 | 13 | 5 | 3 | 2 | No |
| China | 1 | 11 | 3 | 3 | 2 | Yes |
| Indonesia | 3 | 12 | 6 | 2 | 2 | Yes |
| Korea | 6 | 9 | 4 | 3 | 2 | No |
| Malaysia | 5 | n.a. | n.a. | 3 | 2 | No |
| Philippines | 7 | 11 | 6 | 3 | 2 | Yes |
| Thailand | 10 | 10 | 0 | 3 | 2 | Yes |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

**Table 4.7: Official supervisory variables in a global perspective**

| | Supervisors per bank | Official supervisory power | Prompt corrective power | Restructuring power | Declaring insolvency power | Independence of supervisory authority |
|---|---|---|---|---|---|---|
| Vietnam | 3.0 | 11 | 0 | 3 | 2 | No |
| Developed countries | 0.94 | 11.08 | 1.19 | 2.50 | 1.27 | n.a. |
| Developing countries | 3.13 | 11.11 | 2.27 | 2.60 | 1.62 | n.a. |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

[18] It is analyzed whether the supervisory authorities have the authority to take specific actions to prevent and correct problems. The index rates between 0 and 14, with higher values indicating greater power

It would thus appear that while Vietnamese legislation is equal to or outperforms that of other countries of the region the autonomy and power to rapidly implement these laws is lacking in Vietnam compared to the other countries in the region. Given that a swift regulatory response is a key determinant of the ability of a country to successfully avoid a financial instability this is a serious shortcoming of the Vietnamese regulatory framework, which has to be addressed. This is further analysed in Section 5.2, which contains an assessment of SBV independence according to three different components of central bank independence.

Up until recently the distinction between the profit taking and the social duties of banking system was not clear in Vietnam. In addition, the uniqueness of banks as financial intermediaries is not well recognized, possibly due to past and to some extent present (see Section 6.2.2.3) practice of using financial institutions as means for implementing government policies in the pre-transitional period. As consequence a clear, generally agreed upon distinction between financial intermediation and social duties, is still not available. This also affects the general perception of banks and banking functions among especially the Vietnamese households. Here, a bank is regarded as a safe, a broker, or a distributor of government funds. Banking functions such as risk sharing, screening, and monitoring that are elsewhere regarded as intrinsic to banks have not until now been sufficiently acknowledged or emphasized in the Vietnamese context.

These factors have undoubtedly contributed to households' preference for real assets to financial assets, which have kept them from forming a banking habit. The very same factors are likely to have dampened bank motivation to initiate financial innovation, leaving deposit products simple. The end-result can be a vicious circle where savers do not use the banking sector partly because the products on offer are not perceived as attractive, and the banking sector refrains from developing and supplying long-term and/or more advanced products because demand is low.

Another constraint on banking sector possibilities to offer more advanced products is, however, the legislative and regulatory framework for government attempts to regulate and possibly control the level and trend of activities in the banking sector. While it will be difficult to separate the overall demand effect mentioned above from the more direct legislative effect, one can compare bank activity supervision and regulation across countries from South East Asia. This provides an indication of whether the Vietnamese framework differs substantially from that of other countries in the region.

Table 4.8 and 4.9 contain five indicators that give an indication of bank activity regulatory variables and measures of the degree of regulatory restrictiveness on the mixing of banking and commerce. It can be seen that the banking sector in Vietnam is very restricted when looking at which activities banks can engage in. Banks in Vietnam are generally prohibited from engaging in securities, insurance and real estate markets (index = 4), where in most other developing countries it is permitted (index = 2) or somewhat restricted (index = 3). However, Vietnam does not differ much from neighbouring Cambodia or China.

**Table 4.8: Legal restrictions on banking activity in South East Asia**

| | Securities activities | Insurance activities | Real Estate activities | Bank owning non-financial firms | Non-financial firms owning banks |
|---|---|---|---|---|---|
| Vietnam | 4 | 4 | 4 | 2 | 3 |
| Cambodia | 4 | 4 | 4 | 2 | 1 |
| China | 4 | 3 | 4 | 3 | 4 |
| Indonesia | 2 | 4 | 4 | 4 | 1 |
| Korea | 2 | 2 | 2 | 3 | 3 |
| Malaysia | 2 | 2 | 3 | 3 | 3 |
| Philippines | 1 | 2 | 2 | 2 | 3 |
| Thailand | 2 | 2 | 2 | 3 | 3 |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

**Table 4.9: Legal restrictions on banking activity in a global perspective**

| | Securities activities | Insurance activities | Real estate activities | Bank owning non-financial firms | Non-financial firms owning banks |
|---|---|---|---|---|---|
| Vietnam | 4 | 4 | 4 | 2 | 3 |
| Developed countries | 1.37 | 2.22 | 2.04 | 2.22 | 1.77 |
| Developing countries | 2.04 | 2.90 | 3.19 | 2.53 | 2.13 |

Source: Calculated using information in Barth, Caprio and Levine (2001a, 2001b), and information from the World Bank office in Hanoi.

The question of which organizational structure is most appropriate for banks to better ensure a well-functioning banking industry has generated considerable controversy and debate among financial sector specialist. One side argues that allowing for diversification of bank business operations may be beneficial because it makes it possible for banks to capitalize on synergies that originate from these complementary activities.

The competing, negative point view identifies several reasons for why it might be beneficial to restrict the degree to which banks can engage in very diverse financial activities such as securities, insurance, and real estate activities etc., see also Barth, Caprio and Levine (2001a). These include:

1. Conflicts of interest may arise when banks engage in such diverse activities. Banks may, for example attempt to dump securities on or shift risk to ill-informed investors so as to assist associated firms with outstanding loans.

2. To the extent that moral hazard encourages riskier behaviour by banks, they will have more opportunities to increase risk if allowed to engage in a broader range of activities.

3. Broad financial activities and the mixing of banking and commerce may lead to the formation of extremely large and complex entities that are extraordinarily difficult to monitor.

4. Moreover, large institutions may become so politically and economically powerful that it becomes very difficult (if not impossible) to discipline them.

5. In addition, large financial conglomerates may reduce competition and hence potentially the efficiency of the sector.

As the theoretical discussion remains unsettled, one inevitably turns to empirical analyses to see whether a clearer conclusion emerges here. First, the afore-mentioned recent cross-country empirical analysis by Barth, Caprio and Levine (2001a) indicates that restricting banking activities is negatively associated with bank development. Second, it is found that restricting banks from engaging in securities activities is strongly, negatively associated with less bank development. Third, the diversification of income sources through non-traditional bank activities is found to be generally positively associated with bank stability, especially in economies with active non-bank financial markets.

The fact that a recent empirical analysis indicates that fewer regulatory restrictions on the activities of banks have a beneficial effect on banking sector development and stability, gives food for thought. One potential explanation for this finding is that the exploitation of economies of scale is beneficial to the development and stability of the financial sector. Furthermore, banks could get incentives to behave prudently if fewer regulatory restrictions increase the franchise value of banks. Also, one can speculate as to whether the enhanced stability results from the broader activities that diversify income streams and thereby create more stable banks. Finally, one could argue that high levels of government restrictions promote government power, and thereby (perhaps) create a bigger role for corruption, hindering bank performance and stability. While this is speculative, one has to admit that the results from and the discussion about the results by Barth et al. indicate that it may be worthwhile considering liberalizing the laws regarding which activities Vietnamese banks are allowed to engage in.

## 4.5 Setting Accounting Standards

Accounting and provisioning practices have come much in focus recently. Especially the classification of bank loans into relevant categories referring to their quality and loss provisions of different amounts based on this classification has been an important parameter for bank supervisors. Practically this has meant that if interest on a loan is in arrears by more than 90 days, accounting standards will forbid the bank from showing that interest as already having accrued in its income statement.

Developing and implementing proper accounting and auditing standards is thus a must if the regulatory framework and prudential regulations are to be strengthened in Vietnam. With respect to prudential regulations, this includes introducing and consistently enforcing exact concepts of non-performing loans and loan-loss provisions. It must, however, be emphasized that compliance with the regulations has to be strictly and transparently supervised. During the 1990s banks were not required to submit accounts to independent audit. SBV acted as auditor to the local banks, while JSBs and foreign banks were given the choice of independent audit. Local banks were not required to disclose their financial statements although most provide financial summaries in their annual reports. Only three JSBs (VP Bank, Asia Commercial Bank, and Maritime Bank) handed in independent audits as required by foreign investors prior to their subsequent purchase of equity stakes.

Looking at Tables 4.6a and 4.10 it can be seen that, as in most countries, an external audit is required of the financial statements of banks in Vietnam. Furthermore, this has to be by a licensed or certified auditor. This audit indicates the presence of an independent assessment of the accuracy of financial information released to the public. The second variable shows that there is no explicit deposit insurance scheme in Vietnam, which is common for about half of all developing countries. The last variable measures the degree of how informative bank accounts are, where higher values indicate more informative accounting. Bank accounting standards in Vietnam as well as in Cambodia, China and Thailand are below average for developing countries, indicating a regional need for improving accounting standards.

**Table 4.10: Accounting variables in South East Asia**

| | Certified audit required (0-1) | No explicit deposit insurance design (0-1) | Bank accounting (0-3) |
|---|---|---|---|
| Vietnam | 1 | 1 | 2 |
| Cambodia | 1 | 1 | 2 |
| China | 0 | 1 | 2 |
| Indonesia | 1 | 0 | 3 |
| Korea | 1 | 0 | n.a. |
| Malaysia | 1 | 1 | 3 |
| Philippines | 1 | 1 | 3 |
| Thailand | 1 | 0 | 2 |

Source: See Table 2 and The Banking Legislation in Vietnam Decree No. 166/1999/ND-CP and Circular No. 92/2000/BTC (SBV, 2000).

**Table 4.11: Accounting variables in a global perspective**

| | Certified audit required (0-1) | No explicit deposit insurance design (0-1) | Bank accounting (0-3) |
|---|---|---|---|
| Vietnam | 1 | 1 | 2 |
| Developed countries | 0.96 | 0.08 | 2.54 |
| Developing countries | 0.92 | 0.51 | 2.66 |

Source: See Table 3 and The Banking Legislation in Vietnam Decree No. 166/1999/ND-CP and Circular No. 92/2000/BTC. (SBV, 2000).

Looking more closely at the Vietnamese legislation in this area it appears that Vietnam is using a different and non-standard definition of when a loan is classified as non-performing loans (NPLs). The accounting system is furthermore not transparent and auditing not yet compulsory. Interest accrual on NPLs is allowed for up to 180 days for unsecured loans and 360 days for secured loans in Vietnam. Thereby the current loan classification system does not conform to the international standard since loans overdue for 90 days are not classified adequately. The classification system also does not reflect the credit risk based on the borrower's repayment capacity, collateral coverage, and other factors. Over half of NPLs have been overdue for more than 180 days in Vietnam.[19]

Recently Vietnam has agreed to take steps in order to improve the assessment of bank performance in general and for SOCBs in particular. Regulations will be revised where necessary to ensure accurate assessment and accounting. In addition, the four large SOCBs will undertake independent audits using international standards, and the loan classification system (Decision 284) has just been amended and has moved the loan classification and loan-loss provisioning closer to international standards. So issues relating to accounting standards are clearly moving in the right direction in Vietnam, but given the image emerging from the indicators depicted in Table 4.6 this is also needed.

## 4.6 Safety Net, Capital Adequacy and Deposit Insurance

Safety net policies are designed to address the potential problems of the fragility of financial systems, including the prevention of bank runs and bank failures. Capital adequacy and deposit insurance are important components of the safety net. On the positive side, safety nets are designed to reduce the incentives for banks to take risks and depositors' incentives to withdraw their funds. But on the other hand there is an adverse effect of such a scheme. For example the presence of deposit insurance scheme may lead depositors to disregard risks of bank failure. Thereby the deposits are governed by highest interest rates on the basis of risky investments and loans.

Tables 4.12 and 4.13 list a number of variables, which describe the level and nature of capital regulation. It can be seen that Vietnam has very restrictive requirements regarding the amount of capital that a bank must have compared to other countries in the region. The capital regulatory index for Vietnam is more in line with what is observed in developed countries than in developing countries.

Against this background, the beneficial effects of the newly adopted regulation to strengthen the prudential framework in respect of capital adequacy ratios in Vietnam can

[19] For a more in-depth analysis of the NPL problems in the banking sector and the measures proposed to address these, see Chapter 5.

be questioned. From a theoretical point of view, regulation on capital adequacy can have both positive and negative effects on financial development. Capital requirements may serve as an incentive against engaging in high-risk activities. Yet, negative effects may occur due to the difficulties of regulators and supervisors in setting capital standards that mimic those that would be demanded by well-informed private market participants.

**Table 4.12: Capital regulatory variables in South East Asia**

| | Overall capital stringency (0-6) | Initial capital stringency (0-3) | Capital regulatory index (0-9) |
|---|---|---|---|
| Vietnam | 5 | 1 | 6 |
| Cambodia | 3 | 1 | 4 |
| China | n.a. | 3 | n.a. |
| Indonesia | 2 | 3 | 5 |
| Korea | 5 | 1 | 6 |
| Malaysia | 1 | 2 | 3 |
| Philippines | 2 | 1 | 3 |
| Thailand | 3 | 2 | 5 |

Note: Higher values indicating greater stringency

Source: See Table 2 and The Banking Legislation in Vietnam Decree No. 166/1999/ND-CP (SBV, 2000).

**Table 4.13: Capital regulatory variables in a global perspective**

| | Overall capital stringency (0-6) | Initial capital stringency (0-3) | Capital regulatory index (0-9) |
|---|---|---|---|
| Vietnam | 5 | 1 | 6 |
| Developed countries | 4.19 | 1.85 | 6.08 |
| Developing countries | 3.20 | 1.46 | 4.65 |

Note: Higher values indicating greater stringency

Source: See Table 3 and The Banking Legislation in Vietnam Decree No. 166/1999/ND-CP (SBV, 2000).

Looking at the empirical evidence in this area, Barth, Caprio and Levine (2001a) find no robust relationship between capital regulatory restrictiveness and bank development. Furthermore the relationship between the stringency of official capital requirements and the likelihood of a crisis is not strong.

As described above safety nets that are designed to deal with the potential problems of financial systems are often subject to critique, and have in many countries been identified as one of the sources to financial fragility (World Bank 2002). Deposit insurance encourages excessive risk-taking behaviour, and in some countries where the relevant regulation and supervision to encounter such behaviour has not yet been fully developed, badly designed safety nets can undermine the incentives of the participants in the financial system. On the other hand deposit insurance schemes provide protection. For example if too many depositors attempt to withdraw their funds at once, an illiquid but solvent bank can fail.

Barth, Caprio and Levine (2001a) do not find a strong link between the generosity of the deposit insurance system and bank development. On the other hand they find a very strong link between the generosity of the deposit insurance system and bank sector fragility. This result is consistent with the view that deposit insurance not only substantially aggravates moral hazard but also produces deleterious effects on bank fragility. The results suggest that the reverse incentives effects from deposit insurance overwhelm any stabilizing effects that these safety nets may also have. Given these results, it is not clear that the implementation of an explicit deposit insurance design in the Vietnamese financial sector will have beneficial effects on bank development. In any case, the results emerging from the Barth et al. study indicate that local analysis of conditions and local adaptation to specific characteristics and conditions are prerequisites for any future thoughts in this direction

## 4.7 Concluding Remarks

Key points emerge from the comparison of the conditions for and the performance of financial sectors in Vietnam and other countries in the region.

Analysing the competitive pressure in the Vietnamese financial sector, it was found that although Vietnam in recent years has levelled the playing field for new entrants somewhat, there is still much to be done before the Vietnamese banking environment can be characterized as competitive or even partly competitive for that matter. This implies that the Vietnamese government should consider policies that could make local financial markets more contestable.

Given that the concentration in Vietnam coincides with substantial state ownership, one option that could make the financial market more contestable would be to strengthen the already initiated efforts to privatise the four majors SOCBs. This is, however, a lengthy process, starting with the recently completed international audits and the subsequent attempts to address the NPL problem in the SOCBs, which must precede any attempt to recapitalise the major SOCBs (see Chapter 5). Only hereafter would it be realistic to consider any form of privatisation of the SOCBs.

Another approach to making financial markets more contestable, which builds upon the indications that banking sectors in Vietnam and other developing countries tend toward concentration and lack of competition, is liberalizing the comparatively strict entry requirements. In this context it is important to emphasize that any new entry allowed should be gradual, so that the franchise value of local banks does not erode quickly, causing instability and potentially a financial crisis. In addition, Vietnam must maintain some limits on entry for prudential reasons. As a consequence, any liberalization of the entry process must be both managed over time and transparent.

If entry requirements are loosened, evidence from other transitional economies indicates that an increasing number of foreign banks will apply for entry into the Vietnamese market. In this case the beneficial effects of foreign entry are likely to be pronounced in Vietnam, where local banks typically have high overhead cost as and low profitability relative to entrants. The technological and efficiency advantages often harnessed by foreign banks is thus likely to be strong enough to overcome informational disadvantages they may have in lending and/or the ability to raise funds locally. It is, however, very important that the foreign banks are given the opportunity to compete directly with the domestic banks. Foreign entrants should therefore not be directed into the gaps/sectors not served by the domestic institutions but rather compete directly and on equal terms with these. In short, foreign banks should be substitutes to domestic banks rather than complement them. In this context it is, however, also important to take the potential negative effects of increased foreign bank presence into account. This is so, in particular, for the increased risk of financial sector volatility due to the increased exposure to international capital flows and the potential erosion of the franchise values of domestic banks.

Prior to opening the sector to new and most likely more sophisticated entrants, the Vietnamese government must, however, strengthen the capacity and autonomy of the regulatory framework. Our analysis points to the following areas:

- The promptness by which the regulator can or will respond to problems in the financial sector is generally lower in Vietnam than in the other countries in the region. Hence, while Vietnamese legislation is equal to or outperforms that of other countries of the region, the autonomy and power to rapidly implement these laws is lacking in Vietnam compared to the other countries in the region.

- Moreover, the Vietnamese banking system appears to be very restricted when looking at the type of activities banks can engage in. Banks in Vietnam are generally prohibited from engaging in securities, insurance and real estate markets. Activities, which are permitted or only somewhat restricted in most other developing countries.

- Bank accounting standards in Vietnam are below the average level of developing countries, indicating a regional need for improving the accounting standards. The fact that the same is the case in Cambodia, China and Thailand should not be used as an excuse for not addressing this problem – rather the contrary.

- Finally, it was found that Vietnam has very restrictive requirements regarding the amount of capital that a bank must have compared to other countries in the region.

However, given that recent cross-country research indicates that differences in legal origin continue to help explain the development of financial institutions today, even after controlling for other aspects of the overall framework in which financial sectors operate, it would appear that Vietnam faces a difficult task in reforming the financial system. The reason is that the French legal origin may imply that Vietnam has some institutional barriers, which have to be overcome in an effort to reform the financial sector. The subsequent chapters will look at current efforts to reform central parts/functions of the Vietnamese financial system, namely the State Bank of Vietnam (Chapter 5) and the major SOCBs (Chapters 5 and 6).

# 5 Building a Central Bank

The State Bank of Vietnam (the SBV) holds a central position in both the day-to-day workings of the financial sector and in the plans to transform the financial sector towards a higher degree of market orientation. This central position in part rests upon the significance and powers bestowed upon a central bank, and in part on the continued existence of structures and procedures that have remained in place from the epoch prior to the Doi Moi financial sector reforms in 1988. One could claim that the importance of the Vietnamese central bank exceeds that of a central bank in an 'average developing country' due to the parallel existence of a 'planning legacy' (see Chapter 2) that continues to exert considerable influence on the current day financial sector. This legacy exists because although the creation of the large state owned banks heralded the initiation of a two-tiered banking system, the transformation of the SBV into a modern central bank responsible for price stability and financial sector stability necessitated the completion of a lengthy and still-ongoing process of dual separation. On the one side, the SBV had to be separated from actual banking operations in order to focus on supervision and control of financial institutions and markets and management of money and credit aggregates. On the other side, the SBV had to be separated from the political planning system in order to operate as an autonomous entity on par with the executive, legislative and judiciary branches of government.

Following a brief historic overview of central bank operations in Vietnam over the period 1951-2001, Section 5.2 will assess and discuss the process of dual separation of the SBV. Subsequently, Section 5.3 will look at how the SBV manages and controls selected financial markets in Vietnam, including a potential issue of international bonds, while Section 5.4 will deal specifically with the issue of overdue debts in the banking system and the measures proposed to deal with these.

## 5.1 Brief History of SBV

The history of the SBV takes it's beginning with the Second National Party Congress held in 1951 in Tuyen Quang, where the SBV was established as part of the infrastructure put in place in the Northern provinces controlled by the Viet Minh. From 1951 to 1954, the main duties of the SBV encompassed financial transactions and a rudimentary set of central bank functions. This included the control of the issuance of bank notes as well as of monetary circulation, the management of the State Treasury, the management and control of foreign exchange and money transactions, and the mobilisation of funds and the provision of loans for production and commodity circulation.

As the North of Vietnam was liberated in 1954, banking activities were directed towards supporting construction in the North and the Liberation war in the South.[20] When the South was liberated and the country unified in 1975, the SBV banking activities were redirected to restore the economy and to develop the country as a whole. A centrally planned system was applied to the economy as well as the banking system nation wide.

During the period 1976-1989 Vietnam had a one-tier nation wide banking system owned and controlled by the state. As a consequence a monetary market did not develop and commercial banks did not exist in the full sense. However, the restrictions placed on SBV operations and the obsoleteness of this type of centrally controlled monetary policy made financial and monetary conditions difficult. The results were over-expenditure of the state budget, hyperinflation, and serious macroeconomic unbalances.

Facing these circumstances, the Sixth Communist Congress, held in December 1986, was characterized by self-criticism over the party's failure to improve the economy. A new commitment was made to revive the economy and a decision was taken to launch a reform policy. This meant initiating a long-term process of successive reforms aiming at transforming a system previously based on administrative subsidies into one of independence and self-support. Hence, since the Sixth Communist Congress the guiding principle for the reform policy has been to encourage and facilitate the establishment of a multi-component economy and it was in this context that the launch of a process of banking system reforms was suggested. The reform process was initiated by the following two key decisions:

1. On July 3, 1987, the Chairman of the Council of Ministers (the Prime Minister) issued the Decision 218/CT to transform the main function of the state owned banks into commercial banks

2. On March 26 of 1988, the chairman of the Council of Ministers signed Decree No.53/ND on shifting the one-tier banking system towards a business-oriented structure thereby separating and establishing state-owned specialised commercial banks from the SBV.

The key content of Decree 53 was to transform the one-tier banking system into a two-tier system addressing the separation of the SBV from the working financial system

[20] Hundreds of bank staff went to the South to serve during the liberation war.

performing the actual financial transactions. This on the other hand was to be addressed by the state-owned specialised commercial banks. These included: The Foreign Trade Bank of Vietnam, The Commerce and Industry Bank of Vietnam, The Agricultural Development Bank of Vietnam and The Investment and Construction Bank of Vietnam. However, as the decree came into force, in reality, state management and business duties still overlapped. Examples of this included:

- The SBV stipulating that branches of specialised commercial banks should be self-supporting and thereby automatically hindering general directors of the specialised commercial banks to manage their own system.
- In addition, the personnel department of the SBV decided appointments of specialised commercial bank branch managers and assistant managers without conferring with general management of specialised commercial banks.
- Moreover, the Department of Planning and Economics of the SBV was permitted to decide credit quotas and reconcile capital for branches of specialised commercial banks without approval of the banks' general managers.
- Finally, the SBV stipulated that its representative offices were opened beside the branches of the specialised commercial banks and that all specialised commercial bank branches had to transfer capital to the SBV representative offices for payment. This resulted in specialised commercial banks loosing a large amount of their low interest capital. In addition, loan documents of the specialised commercial banks had to be further approved by the SBV, which was cumbersome and time demanding for the private clients.

Hence, although Decree 53 permitted specialised commercial banks to be self-supporting and manage their own system, important day-to-day management decisions were under the authority of the SBV. On the other side, the SBV was not ready to perform the overall control and supervision of the financial system. The SBV had not used monetary management instruments to control and guide monetary markets and the organisational model of the banking system as cumbersome.

The reform process, however, continued in other sectors of the Vietnamese economy. The year 1989 witnessed the initiation of the process of decentralisation in the agricultural sector, the abolishment of compensations for losses due to price controls, and the confirmation of the autonomy of the state owned enterprises in production and business. Within this context the government held the view that economic development had to be based on banking system reform, and that government consequently should concentrate its efforts here.

This resulted in the recommendation of a new, more market-based approach to banking activities that was in line with a new economic management mechanism.[21] As a consequence, a structured plan for the banking system, which included a central bank, an investment bank, state commercial banks, joint stock commercial banks, and joint-venture banks, was proposed. Finally, it was decided to establish and develop the monetary instruments necessary to conduct a more market-based credit and monetary policy.

In May of 1990, the promulgation of two Ordinances on banking established for the first time objectives, duties, and operation purposes of each tier of the banking system. The SBV was now responsible for state management of banking systems and duties of a central bank, while commercial banks where responsible for the operation and control of their finances and the implementation of universal banking activities. Besides four specialised commercial banks, other commercial banks with different ownership were allowed and subsequently created. This included joint stock commercial banks, people's credit funds, joint venture banks, branch offices and representative offices of foreign banks, and financial companies. Table 5.1 outlines the subsequent growth in second-tier banking institutions.

**Table 5.1: Commercial banks (units)**

| | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** |
|---|---|---|---|---|---|---|---|---|---|
| **Urban joint stock banks** | 4 | 16 | 25 | 29 | 29 | 31 | 31 | 31 | 28 |
| **Rural joint stock banks** | 0 | 6 | 16 | 16 | 19 | 20 | 20 | 20 | 20 |
| **Joint venture banks** | 1 | 2 | 3 | 3 | 4 | 4 | 4 | 4 | 5 |
| **Foreign banks** | 0 | 5 | 8 | 9 | 18 | 22 | 24 | 25 | 26 |

Source: Department of banks, State Bank of Vietnam

In short, the two Ordinances on banks promulgated in 1990 formalised the separation of financial and business operations from that of the organisational structure of the State Bank by forming a system of credit institutions directing commercial credit businesses

[21] Vietnamese development towards a market-based rather than a bank-based system is considered in Chapter 7.

and other banking services. As such the ordinances represent an important stage of progress in the banking industry, whereby commercial banking and the organisational practice of private enterprises are disengaged from that of the ministries concentrating on state management functions.

On an organizational level, the issuance of the two Ordinances in 1990 was also an important turning point for the SBV given that the responsibilities of implementing financial transactions were no longer part of the SBV duties. This resulted in significant internal reorganizations in the SBV. Prior to 1990 the organisational structure of the SBV had included four specialised banks: The Bank of Agriculture, The Industrial Bank, The Commercial Bank, and The Foreign Commercial Bank and Saving Fund, but now staff of the State Bank of Vietnam were replaced and transferred in order to fit with the new functions, tasks and organisational structure.

More specifically, one division was transferred to state-owned commercial banks, while the rest was placed in departments of the SBV concentrating on developing and executing national monetary policies, managing business operations of credit institutions, studying proposals and drafts determining regulations and the legal basis for managing monetary business and banking operation of credit institutions and non-banking financial institutions. Other departments such as the policy study department, foreign exchange management department, and the international relations department remained in the organisational structure of the SBV.

From 1990 to 1998, the organisational structure and operations of the State Bank of Vietnam has developed in accordance with the Law on the State Bank and the Law on Credit institutions further strengthening the transformation towards a two-tier banking system. However, as mentioned above the creation of a fully independent central bank essentially entailed the completion of a process of <u>dual</u> separation from the actual financial system, on the one side, and the political system, on the other. While the ordinances and decisions passed in the first phase of the reforms primarily addressed the separation from the actual financial system, the process of separation from the political system was only initiated with the Law on the State Bank passed in October 1998.

The Law on the State Bank defined the role and functions of the SBV to be a government branch, and it reaffirmed the placement of the SBV headquarters in Hanoi and formally made clear that the SBV should take over as the Central Bank of the Socialist Republic of Vietnam. As a consequence, the SBV was recognised as a legal entity with legal capital. The SBV activities were defined to be to stabilise the value of the currency value, secure the safety and stability of the banking system, and promote the development of the economy. Moreover, the Law on the State Bank made it clear that SBV should perform the functions of state management on monetary issues and banking activities, including:

- Participation in the formulation of the social and economic development strategy and plan of the State.
- Development of national monetary policy to be examined by the Government and submitted to the National Assembly for deciding and organising policy implementation. This included a development strategy for banking and credit institutions in Vietnam.
- Develop projects of law and ordinance and other monetary and banking operation projects. Promulgate legal documents and regulations.
- Examine and inspect banking operations, and resolve violations in monetary business and banking operation.
- Represent Vietnam among international credit institutions and banks if mandated by the President and the Government of Vietnam.
- Act as Bank of Credit Institutions and Bank of Monetary Services for the Government.

In addition, the 1998 Law on the State Bank authorized the SBV to perform the following central bank functions:

- Print, issue, exchange, replace and destroy money.
- Refinancing.
- Execute monetary market and open-market function.
- Control international monetary storage and manage foreign exchange.
- Organise the payment system.

The 1998 Law on the State Bank represents an important step towards separating the SBV from the political system and establishing the SBV as an autonomous entity on par with the executive, legislative and judiciary branches of government. Yet, this 'second' process of separation is likely to be as lengthy as the process, which separated the SBV from the actual financial system. As a still on-going process it makes sense to evaluate the current legal and political independence of the SBV. This will consequently be the topic of the subsequent Section.

## 5.2 The Independence of SBV

Central bank independence is an old principle among economists and practitioners of monetary policy whose support has fluctuated considerably over time. This especially appears to be the case when it comes to the discussion of whether and when to push for an independent central bank in a developing country.

One school of thought, starting with Rogoff (1985) has pointed out that the creation of a conservative and politically independent central bank is necessary to reduce the inflationary bias that results from the time inconsistency problem first identified and analysed by Kydland and Prescott (1977). The time inconsistency problem essentially comes about if policy makers are able to persuade the public of a certain inflationary target and the public behaves accordingly. In this case, a government facing an election will have an incentive to create an unexpected expansion of the monetary base, which in turn will lead to lower unemployment (the benefit anticipated by the government) and higher inflation (the price the government is prepared to pay to secure re-election). However, in the case of rational expectations, the public is aware of these incentives and will consequently expect and take into account that the government will deviate from the announced target. The inflationary expectations held and taken into account by the public leave the government with little choice but to validate these expectations. In the simple model, aggregate output in the situation where the government deviates is the same but the level of inflation is above what it would have been if the government had stuck to its rule. This is clearly a sub-optimal situation, which the government and the public have a common interest in avoiding. The solution pointed out by Rogoff and others, is for the government to renege its control of monetary policy by creating a conservative central bank responsible for price stability. Hence, the government effectively ties its own hands in order for the public to attach credibility to the commitment to low inflation.

While empirical evidence appears to support a negative relationship between central bank independence and inflation in the OECD, see Eijffinger and de Haan (1996), for a review of these studies], the empirical evidence is less clear when it comes to developing countries. Using the turnover rate of central bank governors as an incomplete proxy for central bank independence de Haan and Kooi (2000) find that central bank independence is only related to inflation if the high inflation countries (i.e. where annual inflation exceeds 300 percent) are included in their sample of 82 developing countries.

The ambiguous empirical evidence, the possibility of reverse causality,[22] the fact that legal independence seldom corresponds to political independence has given rise to a contesting school of thought based around the claim that central bank independence is overstressed and that problems in implementation have been overlooked (see for example Mas 1995). Leading proponents of this view such as Goodman (1991) and Posen (1994) argue that countries instead of going through the difficult and lengthy process of trying to create a legally and politically independent central bank, should rather seek to create and strengthen a domestic constituency for low inflation. Among the staunchest members of such an anti-inflation constituency would be private banks, which due to the maturity mismatch of assets and liabilities and the non-marketable nature of assets are particularly vulnerable to high inflation.

One could term this the indirect route to obtaining central bank independence, as the creation of private banks in turn will lead to higher pressure for lower inflation, which in turn will induce both low inflation and central bank independence. This rival school of thought may help to explain why, despite having often spent considerable energy in creating autonomous central banks, one fails to find a robust negative correlation between central bank independence and inflation in developing countries. It is often the case in developing countries that the private banking sector is relatively small and subject to extensive regulation. Under such circumstances any influence held by the private sector is likely to be directed at changing the direct regulation instead of being geared at lowering inflation. Hence, the anti-inflation constituencies in these countries are relatively small and without political clout.

The policy advice emerging from this rival school of thought is thus that governments should not waste energy and reputation trying to create an independent central bank, whose autonomy is likely to be violated by the government itself at a later stage of crisis. Instead, the government should opt for a process of building a base of support for lower inflation outside the policy environment. This can take place through deregulation and privatisation of the financial sector that will increase resistance to high levels of inflation and strengthen the advocacy for an independent central bank. In essence, the government following this indirect approach is still seeking to tie its own hands following the same rationale that lead to the recommendation to create an independent central bank following the direct approach suggested by Rogoff. However, the indirect approach might prove to

[22] That is the situation where low levels of inflation although not attributable to the central bank tend to make the central bank more reputable, which in turn allows the central bank to seek greater autonomy

be more credible than the direct given that it involves institutions that are external to the government.

Prior to evaluating whether a direct or an indirect approach to obtaining central bank independence will be the most effective in a Vietnamese context, the analysis will turn to evaluating the present level of independence of the SBV.

Prior to analysing SBV independence, it is, however, necessary to establish how independence is measured. Hermes and Lensink (2000) introduce the following examples of typologies/methods used to enable the identification and discussion of different components of central bank independence:

- **Political vs. economic independence was i**ntroduced by Grilli et al. (1991), and the distinction between political and economic independence can be used to analyse the degree of central bank independence vis-à-vis specific and key central bank policy objectives. Hence, political independence refers to the degree to which a central bank independently can pursue a goal of price stability, while economic independence seeks to uncover the degree to which the central bank autonomously can determine the terms and conditions of credit to the central government.

- **Goal vs. instrument independence** was introduced by Debelle and Fischer (1995), and goal independence measures the extent to which the central bank can set its own policy goals and objectives. Instrument independence, on the one hand, reflects the degree to which the central bank is able to freely choose and assign policy instruments to obtain a given goal.

- **Legal vs. actual independence** was introduced by Cukierman (1992), and legal independence refers to the degree of independence stipulated in the laws governing the central bank. Actual independence is the political independence that results from the interpretation and/or circumvention of these laws.

For the purpose of this analysis, the approach suggested by Cukierman appears the best suited. However, to take into account that actual independence as defined by Cukierman may be affected by factors that are both internal and external to the SBV, we will rely on the following three types of independence:

1. **Legal independence,** referring to the degree of independence stipulated in the laws about the SBV (corresponds to Cukierman's legal independence).

2. **Political independence,** referring to the fact that behaviour and rules do not always coincide. Although a central bank is independent by statute, plenty examples exist of situations where all sides nevertheless accept that government will have its way regardless of the rules. This type of independence therefore seeks to estimate the political capacity and clout of the SBV. In this context, it is important to point out that focus is on restrictions caused by factors that are external to the SBV.

3. **Operational independence** refers to the fact that although a central bank may have obtained both legal and political independence the ability to design and implement its policies in practice is a necessary condition if the other two forms of independence are to result in actual changes. This type of independence is primarily assessed by looking at the human capital in the SBV as well as the strategies in place to attract, augment, and further develop the human capital available.[23] Hence, this component focuses on lack of independence caused by factors that are internal to the SBV.

As it is presented here, the three forms of independence are non-substitutable and necessary if the SBV is to function as a functionally independent central bank. The three forms will be considered in turn as a build up to the final comprehensive evaluation performed towards the end of this Section.

### 5.2.1 Legal Independence

In terms of legislation, the Law on the State Bank is the principal reference and the first legal confirmation of the independence of the SBV. Here and in the law on credit institutions it was stipulated and affirmed that interference in the lawful operations of the state bank and credit institutions is prohibited.

While this clearly represents an important legal confirmation of the independence of the SBV its actual significance can only be evaluated in combination with the actual powers bestowed upon the SBV in the same context. Here the Law on the State Bank stipulates that the SBV is only responsible for the formulation of a national monetary policy and its submission to the government for consideration. The government subsequently submits

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[23] One could also include an assessment of the degree of financial independence of the SBV among the internal factors potentially curbing overall operational independence. Following Beckerman (1997) the financial independence of a central bank is defined as the requisite quantity and composition of central bank capital to make the central bank able to perform a credible and effective macroeconomic management of money and credit.

the perhaps modified national monetary policy to the National Assembly for approval. Hence, the SBV does not have the final word and is not the last to make decisions on issues concerning the national monetary policy. Thus, in comparison with some countries where the Central Banks are not tied to the government, like the FED in the United States and the Central Bank of Germany, the legal degree of independence of the SBV is restricted.

As for the power to make decisions concerning future plans and to conduct monetary and credit policy the SBV is also subject to the direction of the government and in some cases interference of local authorities. The latter appears especially in the municipal and provincial branches of the SBV, where, although the powers and duties of these offices are restricted, operations are frequently interfered and/or disrupted by local authorities. Even in issues that are left for the SBV to decide, the SBV is still required to report to the government for approval. This type of interference can be seen in pieces of regulations that should have been promulgated as decisions of the Governor of state bank but were instead promulgated as decrees of the Government. In addition, the management of foreign exchange reserves and the usage of foreign exchange reserves have to conform to government requirements.

In addition, the legal powers bestowed upon the SBV in terms supervisory activities related to restructuring and reorganising banks was considered and compared with that of other countries in the region in Section 4.4. Here it was found that the Vietnamese authorities were on average bestowed with greater powers than that of other developing countries. However, when we turn to compare the Prompt Corrective Power Index, which measures whether or not the law establishes predetermined levels of bank solvency deterioration that force automatic actions, such as intervention, it was found that the promptness by which the SBV can or will respond to problems in the financial sector is lower in Vietnam than in most other countries in the region. Furthermore, it was found that the supervisory authorities in the SBV have no or low independence from Vietnamese officials but that this was no different from the situation in the other countries in the South East Asian region.

Thus, according to an assessment of the existing legislation, the level of legal independence of the SBV is mixed. A comparison with, for example, the OECD countries would indicate that the Vietnamese central bank is in many respects still a body of the Government, while a comparison with the other countries in the region and developing countries in general would indicate that the level of legal independence of the SBV in a number of areas is at par with or exceeds that which is observed in these countries. The lack of legally stipulated powers to promptly react to violations of the existing legislation is, however, a serious shortcoming, which does not bode well for the subsequent assessment of the level of political independence.

The Law on the State Bank was passed in 1998 in the context of the South-East Asia Financial Crisis, at a time where governments throughout the region where trying to restrict and hamper financial sector volatility and innovation. This highly sensitive time for financial regulation can perhaps explain why the Law on the State Bank, as argued by some experts, stipulates a level of SBV independence, which is below the non-stipulated political level of independence that was bestowed upon the SBV prior to the passing of the law. In this context, it is, however, important to point out that although the specific adverse circumstances at the time of the passing of the law might explain its restrictiveness, it is not likely that they continue to do so – i.e. when circumstances change to the better, the legislation can be changed accordingly.

### 5.2.2 Political Independence

The Law on the State Bank stipulates that the SBV is responsible for managing instruments of monetary policy such as refinancing, interest rates, and foreign exchange rates (Article 15 of Law on state bank, 1998). This is to take place through the use of indirect monetary instruments like the interest rate on the inter-bank market and refinancing conditions and terms. The effect and efficiency of these instruments are, however, low due to the following reasons:

- The development of a market economy is still in its early stages resulting in shallow financial markets characterized by infrequent and low levels of trading and a small number of different financial commodities.
- Although the mechanisms for managing interest rates have improved with the shift from a ceiling-managed mechanism to a basic rate system for VND lending,[24] market forces have not been allowed to prevail due to government interference. As a consequence, the SBV has had to implement lending policies with preferential interest rates for some projects or provide loans under specific instructions, despite the fact that state loans are not allowed to be different from those of commercial loans.

[24] In effect, this represents the first step towards liberalising lending in USD.

As for the SBV management of the inter-bank markets, the prevailing policies of the SBV have not encouraged and attracted private credit institutions to enter the market. The most active participants in the market are still state commercial banks and big joint-stock commercial bank. Accordingly, adjusting interest rates throughout the market has not yet become the intended instrument to control the overall market for credit, thereby essentially restricting SBV independence.

Following the approach introduced by Cukierman, political central bank independence can be approximated by the average turnover rate of the central bank governors, i.e. the average number of changes of central bank governors per year. Although this indicator is clearly not without problems[25], it is an operational measure, which in addition can be measured and compared across countries. As a consequence, the average turnover rate (TOR) of central bank governors has become one of the most widely used and cited indicators of actual (political) central bank independence. Table 5.2 compares the TOR of central bank governors in Vietnam with that of other countries in the region:

**Table 5.2: Turnover of central bank governors (annual average in units)**

| | 1980 - 1989 | 1990 - 1998 |
|---|---|---|
| **Indonesia** | 0.20 | 0.25 |
| **Korea** | 0.40 | 0.50 |
| **Malaysia** | 0.20 | 0.25 |
| **Singapore** | 0.30 | 0.25 |
| **Thailand** | 0.10 | 0.75 |
| **Vietnam**[a] | 0.33 | 0.50 |

Sources: Sturm and de Haan (2001) and CIEM

[a]The list of Vietnamese central bank governors since 1980 is: Tran Doung (1980-1982); Nguyen Duygia (1982-1986); Lu Minh Chau (1986-1989); Cao Sy Kien (1989-1997); Do Que Luong (1997-1998); Nguyen Tan Dung (1998-2000); and Le Duc Thuy (2000-present).

[25] On the one hand, a change of central bank governor might be caused by a multitude of reasons not related to unduly and excessive central government interference. On the other hand, a central bank governor may remain in office for a long time because he/she is acquiescing towards government wishes and priorities.

Accepting the TOR of central bank governors as a proxy for central bank independence, Table 5.2 would seem to indicate that the Vietnamese central bank compared to its regional counterparts enjoys a relatively high level of political independence. In addition, the level of SBV independence would seem to increase in both absolute and relative terms across the two periods considered, which corresponds well with the development and changes outlined in Section 5.1. It should, however, be noted that an inclusion of the most recent period from 1998-2002 is likely to change this relatively good standing of the SBV, as it has experienced no fewer than two shifts of governors over this relatively short period.

Turning to the SBV role as a supervisor of the financial sector, the Law on the State Bank and Decree 88/1998/ND-CP of the Vietnamese Government states that the department of banking supervision is to be headquartered at the State Bank of Vietnam. The department is to advise the SBV Governor on implementing state management and functions of the central bank. The SBV supervision is to be directed by the guidelines of the State Inspector in co-ordination with the Banking Operation Centre of the SBV. However, unlike the directors of departments in the SBV headquarters, who are appointed by the SBV Governor, the Chief of Banking Supervision is appointed by the Prime Minister according to recommendations from the SBV Governor and General Chief of the State Inspector.[26] As a consequence, banking supervision has higher status and enjoys a greater degree of independence than other departments of the state bank. For example, if the Chief of Banking Supervision is in disagreement with the conclusions of the SBV Governor regarding banking supervision, the Chief of Banking Supervision will be able to execute plans, although he must report related matters to the General Chief of the State Inspector. This is the case although the Chief of Banking Supervision is also responsible to the SBV Governor for assigned tasks.

The overall assessment of the level of political independence of the SBV is that the SBV has not, in some cases, made decisions on issues that were within its power but has instead relied on guidance from or the consent of the government. This reflects that in the political system of Vietnam, the SBV as a non-governmental organisation still does not have the status or positioning needed to independently and effectively execute national monetary policies. One should, however, make note of the progress seen within the supervisory activities. This is a positive recent development, which hopefully will result in more accurate, timely, and autonomous supervision and control (see Chapter 4).

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[26] Note, most chiefs of banking supervision are officials from the state bank and that none of them are officials from the Ministry of Finance or a state owned enterprise.

### 5.2.3 Operational Independence

Turning to an assessment of the operational independence of the SBV it is necessary to look more closely at personnel and training issues.

The total number of staff at the SBV is between 6,500 and 7,000. The central office in Hanoi employs 800 people. Some 60, 100, 70, and 30 to 50 people are employed in the Department of Monetary Policy, the State Bank's Inspection Division, the Technology Department and other departments, respectively. Remaining staff work in the 61 municipal and provincial branches and the representative offices. Some of the municipal and provincial branches are overstaffed compared to assigned functions and duties (some offices have a staff of over 100 people). This is a recurring issue, which SBV has not been able to solve due to obstacles resulting from the personnel policy of the state. Movement of staff between the central state bank and municipal and provincial branches in management and operation of the system is generally not recommended by the SBV.

If implemented, the following proposals might improve the operational capacity of the SBV in both the central and the regional and provincial offices:

- Perform a check of the functions and duties assigned to the different units and branches of the SBV in order to avoid overlapping authorities and resulting possibilities to evade responsibilities. The Government will submit a proposal to the National Assembly regarding an amendment to the Law on State Bank (1998) that would create the legal framework for a re-organisation of the financial sector in order to improve management performance.

- Reduce staff numbers in especially municipal and provincial branches. According to government policy and parallel with re-arranging personnel to more accurate positions, the SBV intends to reduce the permanent staff of the State Bank system by 15 percent.

- Develop a pilot project on different models of regional branches that could potentially replace existing municipal and provincial branches. This should include options that strengthen local competence and reduce possibilities for local authorities to interfere.

In order to proactively meet the training and retraining needs of the State Bank system and commercial bank staff, the Banking Institute has been reorganised with a combination of training and research activities. At present, the Banking Institute has one sub-institute in Ho Chi Minh City, seven faculties and a dozen special departments in Hanoi. At present, the Banking Institute selects and trains about 2,000 students and thousands of short-term apprentices as well as some 20 graduate students annually. However, the curriculum taught and the qualifications of the lecturers at the Banking Institute are not comparable with those found in Vietnamese universities. Hence, the reputation and quality of graduate student skills is not as high as desirable.

To improve the effectiveness of State Bank operations, special attention should be made to training and retraining staff of the banking system. At present, the State Bank has expressed much concern about the quality and applicability of the training given. Thus, although the annual number of staff trained is large, the training quality and effectiveness has not met the internal requirements. The curriculum and training methods need to be better suited to the trainees. Accordingly, one solution could be to select qualified young staff for specialised education as well as developing succession plans to adapt with future requirements. More emphasis should moreover be placed on teaching technical skills rather than theoretical issues. In addition, conducting periodical examinations for the selection of staff would seem to be a better mechanism for promotions instead of following the present general promotion scheme based in part on seniority. Implementing these changes will entail thorough renovation of the curriculum, training methods and instructors, and will, as a consequence, require a high-level backing and commitment within the SBV in order to succeed.

In conclusion, the operational independence of the SBV is restricted by an inexpedient organisational structure that permits overstaffing at especially the municipal and provincial offices. The operational independence is further hampered by the insufficient quality and applicability of the training received in internal training institutions.

### 5.2.4 General Assessment

The overall evaluation of SBV independence is that the SBV with its current capacity cannot effectively develop and execute national monetary policies. SBV remains operationally and politically dependent upon support from other government agencies. One could therefore question whether the above mentioned more restrictive Law on the State Bank is the binding constraint. Given that the SBV in a number of cases renege from making decisions that are clearly within its area of jurisdiction and competence, it would appear more likely that lack of political independence is more binding.

Following the above-cited arguments of Posen (1994) and Mas (1995) one could also argue, that it is neither possible nor recommendable to attempt to separate the SBV from the government though direct legislative channels. Instead, one could adopt a more indirect route by gradually building and strengthening a non-governmental lobby for an independent central bank. The preliminary plans for the equitisation of the large state-owned banks represent an important step in this direction, as does the continued presence of foreign banks in Vietnam. The current low levels of inflation experienced by Vietnam naturally imply that anti-inflation [as suggested by Posen (1994) and Mas (1995)] cannot be the common cause under which a private lobby would unite. But one could easily think of other common causes such as banking sector stability and transparency. This might well cause the private banking sector to unite and support a common demand for a more independent central bank.

While this is clearly a long-term process, the short-term priority should be to identify and describe the status, role, and functions of the SBV, as this would improve the chances of strengthening its institutional capacity. If successful, this will in turn allow the SBV to perform according to the relative level of independence already stipulated in the existing legislation.

Finally, a comprehensive assessment of the implementation of functions and duties of the SBV under the Law on State Bank (1998) will be carried out during 2002-2003. This will expose successes and failures as well as lessons experienced. It will also form the basis for a comprehensive plan to complete the banking reform programme in terms of both organisation and operation. This could include:

- Improving the training of SBV staff.
- Decentralising the SBV towards raising powers and responsibilities of SBV.
- Completing the organisational structure of the SBV in order to reduce overlaps, streamline the organisation, and reassign responsibilities
- Reform SBV activities towards concentrating on state management and reduce the government-imposed interference in the activities of credit institutions.

Adopting such policies amounts to following the gradual, indirect route towards increasing central bank independence, which, given the prevailing political and economic environment in Vietnam, is likely to be the most productive and effective approach in the short- to medium-term.

## 5.3 SBV Management and Control of Selected Financial Markets

All central banks have among their principal tasks to ensure the stability and development of the payment system and the banking sector. One way in which the central bank can hope to achieve this is by ensuring and facilitating the development of key markets for financial services and products, thereby giving agents and institutions the choice between financial products that vary in terms, conditions, and liquidity. Consequently, this section focuses on to what extent and how the SBV facilitates the following key financial markets: the market for treasury bills and the inter-bank market for domestic and foreign currency.

### 5.3.1 SBV and the Market for Treasury Bills

In Vietnam, treasury bills and bonds are issued via three channels: the SBV, municipal and provincial branches of the Treasury, and the stock exchange market.

Up to now, the official data on the total value of T-bills and bond issues through municipal and provincial branches of the Treasury have not been published. However, indications are that this amount is not large. The amount of T-bills and bond issues taking place through the stock exchange market is also small. As a result, T-bills and bonds are still issued through the state bank. In the past, funds have been mobilised through the bidding on T-bills and bonds in order to increase credit investment resources and the efficiency of capital. Table 5.3 shows the development of funds mobilisation through the bidding of T-bills and bonds:

**Table 5.3: The market for treasury bills**

| | **1995** | **1996** | **1997** | **1998** | **2000** |
|---|---|---|---|---|---|
| **Total amount (billion VND)** | 243 | 967 | 2913 | 4020,7 | 4766 |
| **Number of auctions (units)** | 4 | 19 | 37 | 44 | 46 |
| **Average interest rate per year (percent)** | 17.2-18 | 7.89-13.8 | 9-11.3 | 11.58-11.4 | 5.2 |

Source: State Bank of Vietnam

As can be seen from Table 5.3, the total value of T-bills and bonds has increased year after year. The amount of T-bills and bonds sold in 1996 was four times larger than in 1995. In 1997, the total bidding amount was three times larger than in 1996, and the bidding amount in 1998 was 1.5 times larger than in 1997. In 2000, T-bills reviews were conducted regularly once a week under Decree No.01/ND-CP dated January 13$^{th}$ of 2000. In 2001, the state bank managed 46 auctions of treasury bills and bonds. In total 90 entities participated in the auctions of which 86, 2, 1, and 1 participant were from state commercial banks, joint stock commercial banks, a foreign bank and an insurance company respectively. The cut-off yield was a closed interest rate with a fluctuation from 5 to 5.8 percent per year. The average cut-off yield in 2001 was 5.49 percent a year.

Related to the auctions of Treasury Bills is the SBV conduct of open-market operations. Here the initial results obtained in the two-year period in which open-market operations have been conducted allow for cautious optimism. In the two-year period from July 2000 up to now, there have been 73 transactions totalling 8,116 billion VND. As a consequence, open market operations appear to have stimulated demand and made a contribution towards carrying out the government and national monetary policy.

There are, however, a number of restrictions, which hamper the further development, and growth of the secondary market for Treasury Bills and government bonds, which is necessary if open market operations are to become an effective instrument for monetary policy. This includes the fact that only T-bills and SBV bills are traded in the market, and moreover, according to the law on the State Bank, only short-term value trades (shorter than 1 year) are allowed in the market. This may hinder the development of a sufficiently deep market as potential participants may find it difficult to obtain a desired level of risk and asset diversification.

The number of participants, who meet conditions to enter this market, is 22. However, in reality and most likely related to the above-mentioned problems only eight credit institutions have made transactions. Among these, it is moreover mainly the four large state owned commercial banks. The limited use of the market and the consequent lack of financial depth in concert with the afore-mentioned structural obstacles restrict open market operations from becoming an efficient indirect instrument for conducting monetary policy as well as a reasonable signal for improved market measures. The result may be a vicious circle were legal/administrative restriction prevent the market from growing and the limited size of the market implies lack of pressure for legal changes and/or limited attention to the problem in the responsible legislative bodies.

The following measures could if implemented perhaps help to break this vicious circle and thus help create an alternative, market-based instrument of monetary policy:

- Amend the laws on the State Bank towards facilitating open market operations. This includes the regulations on entering the market and the rules governing which types of financial products that can be traded.
- Increase the volume of transactions. This includes opening for acceptance of additional legal tender such as deposit certificates issued by a highly liquid 3rd party organisation as adequate value.
- Strengthen the competence of credit institutions. This includes their portfolio management and forecasting skills.
- Supplement and diversify financial instruments transacted in the open market. Here, the State Bank asked the Government and the National Assembly for permission to use long-term legal tenders in the open market. The State Bank is also proposing the Ministry of Finance to issue bonds with different maturities. In addition, the state bank will allow some kinds of bonds from state commercial banks to be issued and traded in the market.

According to persistent rumours, the Ministry of Finance is preparing a draft proposal on issuing government bonds in international markets. Although not directly related to the SBV role as a creator and facilitator of markets, there is good reason to pause and consider possible implication of such a decision. Preliminary assessments indicate that the Ministry of Finance plans to issue for 500 million dollars worth of seven year Euro bonds, which will be accorded a rating equivalent to that of other emerging and/or transitional economies. Various arguments can be identified to provide an explanation for why the government may choose to go ahead with this decision:

1. The fund raised would provide a welcome supplement to already existing sources of government funding
2. Issuing an internationally tradable series of bonds can provide a much-needed anchor for fixing interest rate levels in Vietnam, making it, among other things, possible to produce a yield curve. This will serve to improve the framework and conditions for the other bonds and T-bills issued by the government and the SBV.
3. The successful maintenance of an international series of Euro bonds would provide a clear signal to international investors that Vietnam was moving decisively and competently in the direction of increased reliance on market forces. A signal, which in the long run could improve the country's chances of attracting foreign direct investments.

4. It would, however, also constitute an important signal to Vietnamese society that the country was similar to the ASEAN reference economies – hence contributing to government's strategy of holding on to power through 'performance legitimacy.'

5. Finally, it would improve the opportunities for large Vietnamese companies to attract funds from abroad, as the bond interest rate will provide a benchmark to which a company specific risk premium would be added.

One can also identify potential concerns and downsides for each of the five positive aspects mentioned above:

Ad. 1. There is a potential risk that the government commitment towards the international financial market will 'raise eyebrows' in the donor community. This is so, partly because donors find it harder to justify giving concessional loans and/or international development assistance to countries, which can attract international capital on market terms. Moreover, the servicing of loans to bilateral or multilateral agencies may be 'squeezed' by private creditors in the event of a crisis.

Ad. 2. Analyses of the East Asian financial crisis indicate that an element of financial contagion was at play in the transformation of the crisis from an internal problem in Malaysia to a fully-fledged regional crisis. International investors who in the initial phase of the crisis perceived the East Asian economies as a bloc were to some degree to blame for this. By linking domestic interest rate fixation to the bond series, Vietnam does open a potential channel for importing future financial crises originating in neighbouring economies. Another problem, which could arise, is that the market for Vietnamese government bonds fails to achieve sufficient depth,[27] potentially making the fixation of interest rates volatile and more susceptible to runs and speculative arbitrage. This could, of course, be avoided by abstaining from using the bond rate as an anchor thereby effectively maintaining the almost complete isolation of the domestic financial market.

[27] Note, that preventing this from happening is a very important consideration in the process of deciding the size of the bond issue. However, lack of previous experience with Vietnamese bonds on the international market and the fact that other priorities also influence the design of the bond, does imply that one cannot issue a guarantee that the market will be sufficiently deep if the issue has a total nominal worth of 500 million dollars.

Ad. 3. However, if a decision is made to isolate the Euro bond from the domestic financial market the signal value of issuing international bonds is lessened. Such a decision is likely to have a detrimental effect upon the credibility of the ongoing financial reforms, which in turn can make the bonds less attractive for international investors.

Ad. 4. Related to issues touched upon above, the potential value of the domestic signal will evaporate if the consequences of an international bond issue are imported financial instability and/or loss of international reputation. It is thus a potentially dangerous signal to send to the domestic market as it might undermine the public confidence in the formal financial sector and the economic policies in general.

Ad. 5. Opening up for firms borrowing abroad raises the complexity of choosing how to sequence future financial sector liberalisation. Maintaining a fixed exchange rate increases the amount of dollar denominated loans in Vietnamese firms, and this represents a real risk. By gradually opening for international capital flows without adjusting the exchange rate, makes it more difficult to make any changes to the exchange rate regime in the future. The reason is that any decision to let it float or devaluate would have to take into consideration the effects upon the firm balance sheets. In the event that a future liberalisation of the restrictions placed on trading the VND leads to increased pressure on the exchange rate, the government could face a situation where the consequences of both defending the VND and adjusting it/letting it float would be bad. Recent research into the East Asian Financial crisis indicates that a deterioration of firm balance sheets following the first wave of devaluations was one of the factors, which further augmented the crisis. Troubled firms passed their problems on to the banks – thereby reinforcing the crisis into a vicious circle.

It is thus very important that the Vietnamese government carefully considers and takes into account the potential implications of issuing a series of international bonds. Unless such a decision is thought into a detailed and sequenced plan of financial reforms, which is subsequently adhered to, the short-term gains of issuing international bonds may be erased by erratic and powerful international financial markets. Whether or not the Vietnamese government decides to go ahead is inevitably a political decision, but it is important to consider and analyse all aspects of such a decision.

### 5.3.2 The Inter-bank Market for Domestic and Foreign Currency

The inter-bank domestic currency market of Vietnam was first established in a rudimentary form in 1993 in an attempt to strengthen the role of the SBV in monetary management (World Bank 1995). The Governor of the State Bank of Vietnam established a firmer legal basis for the market in July 1998 following Decision No. 132/QD-NH14, which stipulated that the inter-bank domestic currency market (IDCM) is organized and regulated by the State Bank to assist credit institutions in making an effective use of their capital and ensuring their capacity to meet payment obligations.

The state bank plays the “dual” role of market regulator and market member. It appoints its representative the “Chairman of the IDCM” to be a member of the IDCM. In order to be allowed to participate, a commercial bank has to meet a range of stipulated conditions. These include having an account in the Trade Office of the State Bank, having a representative at the Transaction Centre of the IDCM, and having an internal informational system linking the headquarters to the Transaction Centre.

According to the Status of the IDCM, two types of lending activities are allowed in this market: borrowing to cover a deficit in clearing payments and borrowing to extend a credit (short-term lending). All transactions are carried out in the national currency, VND. This rule is also applied to branches of foreign banks and joint-venture banks.

If a credit institution does not have enough funds to carry out clearing payments, it can borrow from the branch of the state bank where it has opened its account, but for a maturity of up to 10 days only. The member banks may repay their debt to the State Bank before the term of payment at any time, but earlier repayment to other members may be accepted only if these agree.

To link and solve the demand-supply relationship for foreign exchange among credit institutions, Vietnam established an inter-bank foreign exchange market. This was first established in October 1994. Up to 1997, there were 58 participants in the market. The annual transaction volume of foreign exchange among credit institutions was 720 million USD. The transaction volume among credit institutions increased following decision 37/1998/QD-TTg on accelerating management of foreign exchange and decision 173/1998/QD-TTg on the obligation of sale and rights of buy for resident organizations, as well as adjustments in foreign exchange rate circulation. Another factor, which caused the inter-bank transaction volume to increase, was that the transaction volume among commercial banks and their clients also increased remarkably. In the first nine months of 1998, the average transaction volume was 500 million USD per month. This figure was up to 900 million USD in the last three months of this year. But in the year 2000, the transaction volume of the inter-bank foreign exchange market increased by only 9 percent compared to 1999.

## 5.4 SBV Regulation and Supervision of the Financial Sector

Whether or not the supervision and regulation of the financial sector is among the essential, core tasks of a central bank can be discussed. Some analysts like Beckerman (1997) argue that the tasks of managing credit, money and foreign-reserve aggregates are formidable enough, rationalising that central bank directors should focus on these and leave supervision to a specialized supervisory institution. The underlying argument is in part (i) a resource constraint (i.e. that supervision makes heavy demands on central bank directors time and attention), and in part (ii) a potential conflict of interests giving rise to possible moral hazard problems (i.e. that central bank directors could be tempted inappropriately to ease overall money and credit policies in order to ease their own supervision task). At the other end, analysts like Hermes and Lensink (2000) disagree and argue that bank supervision is inherently a central bank function as it assists in maintaining and safeguarding the overall stability of the system.

This divergence of views is also reflected in actual differences in central bank practice across countries. Some central banks like the US Federal Reserve Bank regard supervision of the financial sector to be among its core tasks, while others, like, for example, the Danish central bank have delegated the task to an independent supervisory institution. Moreover, no norm or set of guidelines analogous to commercial banks Basel norms exist for central banks. Hence the decision of whether or not a central bank should perform financial sector supervision is essentially country-specific.

In Vietnam, the still ongoing process to create a two-tiered banking system in combination with the multitude of important issues and problems competing for attention, imply that the question of whether or not supervision is a central bank function has yet to attract attention and debate. We will return to consider this question in the Vietnamese context towards the end of this section. First it will, however, be useful to turn to a description of how the SBV conducts its supervision. This will be followed by the identification and discussion of problem areas and potential solutions related to SBV supervision.

In the one one-tier banking system, banking supervision did not exist. Only after the ordinances on the state bank came into effect in 1990 was supervision of the banking organised into a system from the central to the local level. The 1998 Law on the State

Bank represented an important step vis-à-vis ensuring an unambiguous and clear legal foundation for banking supervision. Table 5.4 summarizes the situation before and after the Law on the State Bank.

**Table 5.4: SBV supervision before and after the law on the State Bank**

| | **Law on the State Bank** | **Prior to promulgation of Law** |
|---|---|---|
| **Legal position** | Banking supervision is defined as the professional inspection of the banking sector.<br>Banking supervision is a unit of the state inspectorate at the state bank. | Banking supervision was a unit of the state inspectorate at the state bank. |
| **Functions** | Professional supervision and general inspection. | General inspection. |
| **Purpose** | To secure the safety of the system of credit institutions.<br>To protect legitimate rights and interests of depositors.<br>To support the implementation of the national monetary policy. | Unclear purpose. |
| **Objects** | Organisations and operations of credit institutions.<br>Organisations of operations of non-banking financial institutions.<br>Implementation of regulation on monetary and banking issues of institutions and individuals. | Organisations and operations of credit institutions.<br>Organisations and operations of institutions belonging directly to the State Bank. |
| **Principle** | Banking supervision only abides by the Law to insure accuracy, objectiveness, transparency, democracy, and timing.<br>Banking supervision must not suffer interference from other | The principles on inspection were stipulated in the ordinance on inspection in general. |

| Table 5.4: SBV supervision before and after the law on the State Bank | | |
|---|---|---|
| | **Law on the State Bank** | **Prior to promulgation of Law** |
| | authorities. | |
| Source: Tou (2001) | | |

While the Law on the State Bank represents the current legal basis for SBV supervision, banking supervisors are also subject to the Law on credit institutions and other regulations, including ordinances on inspection, ordinances on resisting corruption, the Law on complaint accusation, and ordinances on penalising administrative violations.

On an organisational level, banking supervision at the SBV includes the following offices and divisions: state commercial bank supervision division, joint-stock commercial bank supervision division, branch of foreign bank supervision division, analysis and inspection division, division of judgement on complaint and supervision units of the SBV at municipal and provincial branches (supervision units). The Organisation of supervision belongs to municipal and provincial branches but the Chief of Banking Supervision directs it. Duties of supervision units are to inspect activities of branches of local credit institutions. The current number of staff in the banking supervision department is 200, of whom 100 are assigned to the central office while 100 are supervisors at the municipal and provincial branches. Again, the 1998 Law on the State Bank brought about considerable changes in the organisation of supervision – changes that are summarized in Table 5.5.

| Table 5.5: SBV supervision before and after the law on the State Bank | | |
|---|---|---|
| | **Law on the State Bank** | **Prior to promulgation of Law** |
| **Authority** | Central banking supervision of the SBV and banking supervision of municipal and provincial branches. Instructions, conducts and assignments between central and municipal and provincial banking supervision are systematic. | Central banking supervision of the SBV and banking supervision of municipal and provincial branches. A vertical system of banking supervision was not clear. |
| **Leadership** | Chief and assistant chiefs at the central banking supervision. Chief and assistant chiefs at municipal and provincial branches. | Chief and assistant chiefs at the central banking supervision. Chief and assistant chiefs at municipal and provincial branches. |
| **Duties** | Implementing banking supervision. Implementing functions of a unit of state inspection. | Duties were not made clear. |
| **Powers** | The SBV can decide upon, recommend and carry out the penalisation of administrative violations. In addition, the SBV were given the right to make propositions for new ordinances and legislation and the powers to perform inspections. In addition, if the SBV disagrees with government decisions an official note of the SBV will be kept in the official records. The chief of banking supervision at the central level and the municipal and provincial branches were given the power to suspend the implementation of illegal regulations, to suspend the | The SBV could decide upon, recommend but not carry out the penalisation of administrative violations Other powers were not clear. |

| Table 5.5: SBV supervision before and after the law on the State Bank | | |
|---|---|---|
| | **Law on the State Bank** | **Prior to promulgation of Law** |
| | implementation of punishment, and to warn and suspend individuals who hamper inspection. | |
| **Supervisor standards** | A supervisor at level 1 was required to have at least a three-year experience in the banking sector. | Unclear regulation. |
| **Relationship with related agencies.** | Clear regulation on the relationship between banking supervision and the state inspection, the inspection of other agencies, and the legislative system was established. | No regulation or guidelines |
| Source: Tou (2001) | | |

In the past the supervision practices of the SBV has been subject to criticism. Most notably the World Bank (1995) characterised the on-site inspection performed by the SBV as 'one that is largely bottom-up at the branch or sub-branch level, and with a focus on verifying the accuracy of financial statements'. Moreover, 'the work performed during this period (up till about 1995) was more in the nature of an internal audit, rather than examination'. However, over the last three years a number of measures have been undertaken to strengthen banking supervision. As a consequence, supervision methodology and settlement has been changed:

1. Banking supervision activities are now focusing on assessing and examining the indices of banking activities instead of checking the bank accounts, books and invoices.
2. Distant supervision activities have been improved.
3. Powers and responsibilities of the supervisor are now stipulated more clearly (as described in Table 5.5).

Still, Vietnamese banking supervision activities do not meet the requirements of global standards.[28] First, the model of organisation for the Vietnamese banking supervision system handles both the inspection functions for the banking industry and the judgement and treatment of complaints. In addition to the potential conflict of interest involved with having an operative institution handling complaints about its own conduct, this model of organisation has also caused difficulties with respect to time and focus. Hence, banking supervisors often spend their hours handling complaints rather than inspecting specific banking issues. Second, there is a lack of transparency and of equal treatment between state commercial banks, joint-stock commercial banks and branches of foreign banks. This goes for both the inspection results and the post inspection settlements. Third, the banking supervision system has not yet found a means to efficiently control bad banking debt (see Section 5.5). Fourth, the inspection process for banking supervisors in Vietnam is weak and still not in tune with international standards. There is a pronounced weakness vis-à-vis systematic collection and analysis of data and information on inspection activities. Furthermore, international methods and systems like CAMEL have not been implemented. Table 5.6 compares Vietnamese and international supervisory models:

**Table 5.6: International and Vietnamese models of banking supervision**

| | Vietnamese model | International model |
|---|---|---|
| **Objects of supervision** | Organisation and operation of credit institutions.<br>Banking operations of other institutions.<br>Supervising institutions and individuals how to abide by regulations on monetary issues and banking operations (state management function of the State Bank of Vietnam). | Commercial banks.<br>Non-bank financial institutions. |
| **Scope** | Supervising not only credit institutions but also other credit facilities (as mentioned above)<br>Assisting the Governor in carrying | Supervising commercial bank and non-bank financial institutions. |

[28] According to Financial magazine, 11/2000

| Table 5.6: International and Vietnamese models of banking supervision | | |
|---|---|---|
| | **Vietnamese model** | **International model** |
| | out state management functions, in the judgement on complaints and accusations, and in fighting corruption. | |
| **Powers and duties** | Banking supervisors are only allowed to recommend and propose. They may not grant or abolish licenses, promulgate regulation, and penalise offenders. | Promulgate regulation on:<br>• Organisation and operations: model and standards etc.<br>• Management, control, accounting, auditing etc.<br>• Prudential regulation.<br>• Risk management and settlement.<br>Grant and abolish licenses.<br>Expand and restricting activities.<br>Classify banks.<br>Penalise offenders by imposing a fine or through the suspension of operations and management. |
| Source: Tou (2001) | | |

One reason why the SBV banking supervisors fail to act in line with international standards is the lack of power and competence to change bank accountancy standards to correspond more closely to international standards. In Vietnam bank accounting systems are determined by the overall accountancy standards stipulated by the Ministry of Finance. As a result, the SBV is unable to formulate a bank accounting system outside of the Vietnamese accounting system. The process of changing the overall accounting principles to correspond to international standards has been initiated and is currently under implementation. It is, however a process, which will take time as it involves the formulation of a chart of accounts, the development of an entirely new accounting methodology, and the training of staff.

Hence, if the quality and timeliness of the SBV supervision is to be improved, the following measures need to be considered.

- Changing the inspection and accounting systems of the SBV to comply with international standards.
- Applying current international inspection methods.
- Applying an inspection process that is transparent and acceptable for all credit institutions.
- Training inspection staff in proper banking supervision methods.
- Amending regulations on banking supervision towards strengthening the powers, duties and responsibilities of the inspectors.
- Ensuring equal treatment of all credit institutions.

More specifically, it is possible to identify a number of measures that are likely to improve the supervision of the state owned commercial banks. Note, that these include both measures related directly to the supervisory activities and measures, which reflect upon the overall operating conditions and terms of these institutions. The latter are included to reflect the obvious truth that supervisory tasks are easier and more likely to succeed if performed on financially sound, efficient institutions. The measures directed towards the SOCB include:

- Auditing the SOCBs in accordance with international standards as well as publishing audited results.
- Reforming the SOCB lending process towards strengthening powers and responsibilities of lending and credit institutions.
- Increasing the registered capital of state commercial banks in order to guard banking system capital and profit.
- Addressing the problem of non-performing debts.
- Strengthening internal bank inspection.
- Separating non-commercial and commercial loans in order to shift non-commercial loans towards policy banking (see Section 5.5).

Similarly, it is possible to identify the following measures that are likely to improve the supervision of the joint stock commercial banks.

- Inspect banks plans to increase their registered capital in order to insure their financial capacity.
- For banks that need to be merged, steps of implementation will be supervised.
- Banks under special control need to be inspected carefully by the Committee of the SBV to ensure they abide to existing laws and regulations.

As regards branches of foreign banks, the following direct and indirect measures can be identified:

- Inspection of all foreign bank activities.
- Identify ways in which it is possible to utilise foreign bank expertise and resources to improve staff training in investment, risk management, and internal inspection in domestic banks.

Finally, one can identify the following four measures, which are likely to improve the supervision of the People's Credit Funds.

- Circulating and classifying overdue debt.
- Analysing causes of overdue debt and propose measures to settle it.
- Taking strict measures if serious violations occur during liquidations or in situations of emergency.
- Speeding up the establishment of a Safe Fund – a capital fund developed via people's credit funds to cover losses from operations and systems risk.

In conclusion, there are a number of both direct and indirect measures, which can potentially improve the quality, and timeliness of SBV supervision. A central question, which, however, remains to be addressed, is whether the SBV should continue to perform and be responsible for banking supervision in Vietnam. This is, as stated previously, essentially a political decision. Nevertheless one can identify the following potential benefits from such a separation:

- The SBV directors and staff will be able to focus effort and attention on managing money, credit and foreign exchange reserve aggregates, i.e. the capacity constraint argument made by Beckerman (1997).

- The separation of the supervisory division from the SBV will serve to increase the distance between the SBV and its former operative functions (the current SOCBs), which will minimize the risk of preferential treatment and/or outsider attempts to bias SBV policies and rulings.

- The narrower set of objectives is likely to make the quest for increased SBV independence (see Section 5.4) easier and more feasible. Less conflict of interest will occur and efforts can be more concentrated.

- The potential conflicts of interest between the overall monetary policies and the supervision of the banking sector will be made more transparent and will have to be settled through discussion and negotiation between the two institutions (i.e. the SBV and a new independent bank supervision institution). This could for example be a situation where the bank supervision institution in order to better deal with overdue debt in the banking sector would prefer a more expansive monetary policy.

On the other hand, one should not neglect the operational, political and legal obstacles facing the creation of a new and independent supervisory institution. They range from the costs incurred to political power struggles between the different state institutions. However, as described previously, the supervisory divisions within the SBV have already achieved more operational and political independence. This has taken place through a gradual process spanning the last three to four years, and it is only natural to consider if and when this process is going to stop.

A complete evaluation of supervisory practices of the State Bank of Vietnam (SBV) is planned for the future. The study has yet to begin, but the implementation of the recommendations from this evaluation is to be completed before the end of 2005. One of the issues that will be considered during this process is the establishment of an independent control and audit institution, reporting directly to the Audit Committee of the Board of Directors. In addition, talks have indicated that a completion of the guidelines for how to resolve/intervene in troubled banks will take place. The analysis presented here suggests that the SBV and the Vietnamese government in this process should at least consider the pros and cons of a complete separation of supervisory duties from the SBV.

## 5.5 NPLs and AMCs

Addressing the problem of non-performing loans (NPLs) is a key component of the planned reforms of the banking sector where the SBV plays a pivotal role. The reason for focusing explicitly on bad debts is that lack of corporate debt restructuring constitutes one of the large obstacles to improving bank balance sheets and, consequently, domestic credit availability, particularly to non-state enterprises.

Given the fact that the SOCBs granted the majority of the non-performing loans, many dating years back, to state-owned enterprises in difficulty or under the direction of the government to achieve social or economic objectives, the approach and policies taken to solve the problems faced by the SOCBs will be an important indicator of the overall political will to reform. In other words, does the government have the necessary resolve and political will to address problems that predominantly result from past policy shortcomings?

The exact extent of the problem is not easy to assess. Table 5.7 contains recent estimates made according to Vietnamese accounting standards.

**Table 5.7: Bad debt (share of total outstanding loan volume in percent)**

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| **Entire bank sector** | 9.3 | 12.3 | 13 | 12.5 | 11.4 |
| **State commercial banks only** | 11.0 | 11.9 | 11.2 | 11.1 | 10.8 |
| **Joint stock commercial banks only** | 4.2 | 13.5 | 13.9 | 13.1 | 12.4 |

Source: Assessment of Vietnams Economy (1999) CIEM/Vietnam/Australia and annual report of the SBV, 2000.

The IMF using diagnostic audits based on international accounting standards has, however, estimated that non-performing loans in SOCBs constitute up to 30 percent of outstanding loans over the period 1996-1999. In addition, informal assessments suggest that the ratio of non-performing loans (NPL) to total loan value is substantially higher than 30 percent.

One of the reasons for the huge discrepancy between the official estimate and estimates made by outsiders could be the practice of rolling over old loans, which is believed to be widespread in the Vietnamese banks and in the SOCBs in particular.

Another potential explanation is that Vietnamese banking practices up until recently dictated that provisioning should be made only for the arrears and not for the total loan in the case of loan default. Prior to 1990, the level of making risk provisions was neither based on overdue debt nor was calculated according to risk levels. Instead commercial banks were required to use 10 percent of profits after taxes for risk provisions. This amount was clearly insufficient for the purpose.

This has changed in recent years as Decision 488/2000/QD-NHNN5 dated 27/11/2000, requires that risk provisioning is calculated on overdue debt (bad debt). Moreover, commercial bank assets must be classified into four groups with four associated levels of risk provisioning.

Finally, it was recently proposed to change the calculation of over due debt and adjust risk provisioning to be more in tune with international standards - i.e. that provisioning is based on the risk level at the time the loan is disbursed rather than making provisions for credit risk after the loan becomes overdue. This change was stipulated in Decision 1627/2001/QD-NHNN dated 31/12/2001 concerning regulating the status on providing bank loans between credit institutions and their clients. This caused the ratio of bad debt to outstanding banking loans to increase to about 17-20 percent of total outstanding credit, bringing official Vietnamese estimates more in line with the IMF estimate. In addition, the principles in using Risk Settlement Funds were more clearly stated in the decision, including that risk provisioning funds could only be made to cover losses for which objective reasons can be identified. Moreover, all amended regulations will support credit risk management and the settlement of commercial banks.

The problem of NPL could, however, go beyond the financial sector as no information is available about the magnitude and distribution of inter-cooperate debts between the SOEs and how these relate to bank debts. Experience from other former centrally planned economies indicates that inter-cooperate SOE debts can be of a sizeable magnitude. This can substantially complicate efforts to restructure SOEs and state owned banks as it raises difficult questions of priority and relative importance between SOE obligations to other SOEs versus the obligations towards the state owned banks. In addition, it means that tough decisions have to taken concerning the allocation of the funds available for recapitalisation.

Regardless of whether or not inter-corporate debt of any magnitude exist, holding NPLs of the magnitude cited above (30 percent of outstanding loans) is almost certain to have detrimental effects upon banking sector performance. The general channels through which NPLs can exert negative influence upon banking performance include:

- The diversion of managerial time and skills from other banking activities.
- The reduction in funds available for new loans because funds are used to roll-over and/or ever-green adversely classified loans.
- The loss of depositor and inter-bank confidence reduces incentives to channel savings or investments to the financial sector.

In addition to taxing banking sector resources, NPLs may also have an adverse effect on bank lending behaviour either by making banks averse to risk (fearing additional losses) or by inducing them to take on even riskier loans (to gamble for resurrection). If practiced by the majority of the banks, the former will result in a credit crunch, while the latter is likely to amplify the problem, increasing the probability of a systemic crisis coupled with an overall loss of investor and depositor confidence in the sector.

While it is not possible to document whether or not the NPLs have had a detrimental effect upon lending behaviour in Vietnam, it has become increasingly clear over the last five years that the NPL problem appears to have had negative influence as those mentioned above on banking sector performance in Vietnam.

The initial official response to the recognition that NPLs impeded banking sector performance was one of regulatory forbearance. This essentially involves hoping that economic growth and the ongoing efforts to improve banking sector performance would eventually cause bad debt problems to be resolved without significant financial commitments and/or direct involvement by the government. However, as the necessary improvements in both macroeconomic performance and bank management were slow to appear in the years following the East Asian Crisis, it became clear that following a strategy of regulatory forbearance would not solve the NPL problem.

Hence, to clean up the SOCB balance sheets and address the NPL problem, it was decided to introduce a new type of institution in Vietnam, namely the Asset Management Company (AMC). Using AMCs has to some extent become the standard international response to NPL problems in financial sectors. AMCs have been established in a large number of countries. They include most of the neighbouring ASEAN countries following the financial crisis in 1997-98.

### 5.5.1 AMCs in South East Asia

In general terms, an AMC is an institution established to acquire, manage and recover non-performing assets of troubled or failed financial institutions. In most cases, a government wishing to restore stability and efficiency in the financial sector while at the same time attempting to keep fiscal costs and risk of moral hazard at a minimum has set up AMCs.

Following Cooke and Foley (2000), it is possible to identify three different institutional set-ups that can be used when introducing AMCs in a financial sector:

- A centralised state-owned AMC.
- Several decentralised AMCs operating as separate departments within each crisis-stricken institution.
- Several decentralised AMCs as separate legal entities but each one addressing the particular problems of one of the crisis-stricken institutions.

While no blueprint exists regarding which of the three types of AMC set-ups to employ to a given set of circumstances, Cooke and Foley suggest that the first option, a centralised AMC is to be preferred when the NPL problem is of a systemic magnitude and/or when special legal powers or purpose tailored legislation are needed to override the judicial branch. In addition, Cooke and Foley stress that a central AMC will be the preferred option if the human capital and specialist skills necessary to operate an AMC are in limited supply in the financial sector.

After the financial crisis in 1997-1998, the directly affected East Asian countries were burdened with a large volume of non-performing assets, including nonperforming or past due loans and real estate and other assets pledged as collateral for loans. The magnitude of the problem in the respective countries is evident from Table 5.8. As is the case in Vietnam, several of the depicted countries are thought to have employed a definition of NPLs, which is more lenient than recommended by international standards.

| Table 5.8: NPLs in South East Asia in peak year of crisis, 1998 | | | | |
|---|---|---|---|---|
| | **NPLs in peak year of crisis** | | **Estimated amount of government debt to pay for bank restructuring** | **Annual interest cost of government debt to pay for bank restructuring** |
| | Share of loans in percent | Share of GDP in percent | Share of GDP in percent | Share of GDP in percent |
| **Thailand** | 50 | 70 | 32 | 4.0 |
| **Indonesia** | 70 | 53 | 29 | 3.5 |
| **Malaysia** | 30 | 42 | 18 | 1.3 |
| **Korea** | 35 | 35 | 18 | 2.0 |
| **The Philippines** | 15 | 5 | 4 | 0.5 |
| Source: Cooke and Foley (2000) | | | | |

In their policy response to this problem and with the intent to restore the health of and confidence in the financial sector, all countries chose to create and develop AMCs in 1997-1998. As can be seen from Table 5.9 most countries have chosen to employ a centralised AMC set-up.

| Table 5.9: AMC set-up in South East Asia | | |
|---|---|---|
| | **Initial model** | **Chosen Approach** |
| **Thailand** | Both central and decentralized. | Financial Sector Restructuring Authority (FRA) evaluates finance companies rehabilitation plans and sells their assets.<br>Asset Management Company acts as bidder of |

| Table 5.9: AMC set-up in South East Asia | | |
|---|---|---|
| | **Initial model** | **Chosen Approach** |
| | | last resort for FRA's bad assets. Radhanasin Bank[29] acts as bidder for FRA's good assets. Bank Based Asset Management Companies work out NPLs for commercial banks (both private and state). |
| **Indonesia** | Decentral | Indonesian Bank Restructuring Agency supervises banks in need of restructuring and manages assets acquired in the bank restructuring process. |
| **Malaysia** | Central | Special purpose vehicle for the management and disposition of banking system NPLs |
| **Korea** | Central | Special purpose vehicle for the management and disposition of banking system nonperforming assets. |
| Source: Cooke and Foley (2000) | | |

According to Rajan and Bird (2001) all of the above mentioned economies have made 'some headway in reducing NPLs'. In Korea and Malaysia the combined effect of the nascent economic recovery and the AMC effort have caused a reduction in NPL ratios for commercial banks to less than 10 percent. In contrast, NPLs have remained high in Thailand (about 30 percent), a fact that Rajan and Bird cautiously attribute to the Thai government's preference for a market-based approach to financial restructuring. In Indonesia, the central AMC is estimated to control approximately 75 percent of total NPLs, but the combination of powerful, uncooperative borrowers and an inadequate legislative framework continue to hamper the subsequent recovery and restructuring of assets.

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[29] Radhanasin Bank (RAB) was initially created to manage quality assets of the failed finance companies, leaving the bad assets to the AMC. In January 1998, however, the government announced that RAB would no longer serve in this capacity but instead act as a commercial bank.

In their 2000 survey of AMCs in East Asia, Cooke and Foley assess individual country experience using AMCs and distil valuable lessons from the first years of AMC in South East Asia. While identifying problems and hurdles in all countries studied, Cooke and Foley specifically note, that the decentralised approach chosen in Thailand is not without problems. To be more specific, the bank based AMCs did not appear to be guiding and coordinating their efforts to resolve the country's NPL problems. Still plagued by a high level of non-performing loans, the Thai government in February 2001 finally decided to establish a nationwide AMC with broad special powers to resolve the critical situation of the banking sector.

Regardless of whether a centralised or decentralised approach is chosen, Cooke and Foley point to the following key lessons, which should also be considered in a Vietnamese context:

1. Addressing the NPL problem is <u>not</u> equivalent to addressing the factors responsible for creating the problem in the first place. Failure to address the causes of the NPL problems is to invite a repetition. A realistic assessment of the cause, size and character of the problem is the key starting point for attempts to address the NPL problems.

2. Prior to establishing the AMC, the government must assess the legal infrastructure. Among other things this implies ensuring that the legal system and legal powers are in place to permit an effective and swift case management and that bankruptcy, tax, property ownership, collateral and foreclosure laws are both adequate and reflected in court rulings. If the legal infrastructure appears inadequate measures must be taken to bestow the AMCs with the necessary special legal powers and/or legislation.

3. The use of AMCs and the issue of resolving NPLs is a complex matter, and the government should consider establishing an independent supervisory board responsible for the balanced, non-partisan oversight of the efforts and results. The board should have both industry and government representatives. It should <u>not</u> be directly involved in the daily operations.

Related to the above-mentioned complexity of the process of establishing and operating an AMC the government should make sure that policies and institutions are developed to promote openness and transparency in the process. Lack of transparency can result in a conflict of interest, or the appearance thereof, which can diminish public confidence in the integrity of the process.

### 5.5.2 AMCs in Vietnam

Several aspects of the NPL problem and the financial sector in Vietnam appear to fit the circumstances under which one would suggest employing a centralised approach. This includes:

- The deficiencies in key national legal and judicial frameworks such as those concerning collateral, land ownership, transfer of loans and creditor rights, and land usage rights.
- The need to coordinate NPL assessment and restructuring with ongoing SOE reforms. This includes tackling potentially powerful and politically connected debtors, who might oppose the process and/or seek to take advantage of the situation and the relatively ineffective legal recourse.
- The potential benefits from establishing linkages to the ongoing efforts to reform and restructure SOCBs. A centralised AMC will accord the government with an opportunity to accelerate and guide bank restructuring through the conditions it attaches to the purchase of NPLs.
- The scarcity of managerial and analytical talent in the sector. A single entity will be in a better position to reap economies of scale and make the best use of the human capital available
- The thin or non-existing secondary markets for financial assets make it difficult for separate AMCs to obtain uniform and transparent valuations and conditions of sale, as information is not easily transferred across autonomous decentralised units. In addition, AMC experience in other ASEAN countries have been marred by a lack of interested buyers. A centralised AMC with a more direct government involvement will be in a better position to legitimise the bundling of NPLs and/or to offer discounts if lack of interested buyers also turn out to be a problem in Vietnam.

Following the decision to use AMCs in Vietnam, the State Bank of Vietnam initially reasoned along similar lines and ended up suggesting that Vietnam should establish one central nationwide AMC.[30] A range of political, legal and technical hurdles, however, hampered the implementation of the first choice and forced the SBV to turn to its second

[30] This is in line with Lan (2000), who also suggests that a centralized AMC would be more suitable in Vietnam.

option, the establishment of individual AMCs under each of the major state-owned commercial banks. Thus, to some extent the decision to implement a decentralised AMC set-up against the initial recommendation made by the SBV, one could view this as a consequence of limited SBV independence (see Section 5.2).

To implement the second option, the prime minister initially published an Official Letter in February 2000, allowing state commercial banks to establish companies for debt management and exploitation of mortgaged assets on the basis of an approved plan for the settlement of commercial bank non-performing loans. This plan was, however, modified as the Prime Minister on 5 October 2001 promulgated a new decision on the establishment of a company for debt management and asset exploitation under commercial banks. The new decision, a higher ranked legislative instrument, has a wider application than the previous Official Letter. All types of securities are now covered by the regulation instead of only mortgaged assets.

The overall plan for introducing AMCs into the Vietnamese financial system is to establish loan-workout units (LWU) and asset management companies (AMC) in each of the four major SOCBs. Each AMC will buy the collateralised non-performing loans at market value while the respective LWUs will seek to resolve the non-collateralised loans in each of the four banks.

Although detailed plans on how the AMCs and the LWUs will operate and function are currently not publicly available, some details of the restructuring plan for the Vietcombank (VCB) completed during the fall of 2001 have been made public. The performance criteria for VCB at the end of the three-year reform period include a capital-assets ratio of 6 to 8 percent, a return on assets of at least 0.5 percent, and NPLs below 4 percent of total loans outstanding. As for the NPLs in VCB the plan was to complete the loan classification and recovery plans for loans to the 50 largest debtors of VCB before the end of 2001. Recovery plans for the remaining loans will subsequently be worked out before the end of 2002. The recovery rate for the LWU associated with VCB was tentatively scheduled to gradually increase from 10 percent in 2001, rising to 25 percent in 2002, and 35 percent in 2003.

In addition, the Bank for Investment and Development of Vietnam (BIDV) recently (January 2002) announced that it has set up its own AMC. Some details of the organization and objectives of this company were also made public, including:

- The AMC responsible for the BIDV has an initial chartered capital of VND 30 billion, and will inherit from BIDV all outstanding debts, both secured and unsecured, as well as the assets pledged for such debts. It is hoped that the AMC will secure at least VND40 billion in bad debts.[31]

- The AMC will be authorized to sell assets mortgaged with BIDV at market prices to the public through the Auction Service Centre, or to other AMCs.
- In addition, the AMC will be given the powers to restructure outstanding debts by rescheduling, cutting interest rates, and transferring debts into investment.

On the operational side the BIDV AMC plans to complete categorization of loans given to discharge Government policies and commercial loans, and handle outstanding debts to assign lending before the end of 2002. It will also strive at tackling over 60 percent of overdue debts in 2002.

As for debt restructuring in private banks, two recent government decisions indicate that the government would like to facilitate and speed up debt restructuring in the private sector: The decision in October 2001 allowed commercial banks to set up their own AMCs, and in a directive dated 7. January 2002, the State Bank Governor gave commercial banks greater autonomy in handling overdue debts.

Given the limited and fragmented information about the nature and extent of the NPL in the Vietnamese banking system in combination with the fragmented information about the specific conditions under which the AMCs will operate make any predictions of future performance and success rate very difficult. One can, however, point to three key issues, which regardless of the unresolved/unknown issues will have central importance for the efforts to resolve the NPL problem in Vietnam. The three issues, which will be discussed in turn below, are:

- The autonomy and legal power of the decentralised AMCs.
- The initial assessment and understanding of the problem.
- The recruitment and training of skilled personnel.

#### 5.5.2.1 Autonomy and legal power of decentralised AMCs

As will be evident from the analysis conducted thus far, the SBV decision to establish decentralised AMCs implies that they will almost inevitably have less power than a

[31] By the end of 2001, BIDV had total outstanding debts of VND42,500 billion.

nationwide AMC established through a law adopted by the National Assembly. The fact that the SBV itself first opted for a centralised set-up does, however, imply that criticism of the decision to choose a decentralised model would not be constructive at present. Instead, an interesting question is whether the Vietnamese approach will have a better success rate than in Thailand where a decentralised model was recently discarded? If not, the first option of a nation-wide AMC would still be available to the Vietnamese government as it was for the Thai government. Following Cooke and Foley (2000), the following potential benefits of adopting a decentralised approach can be identified.

- Utilization of in-house knowledge of NPL at the particular bank which issued the now non-performing loans.
- Maintaining important banking relationships with debtors.
- Strengthening of loan resolution expertise in the bank.
- Establishing new relationships with investors involved in asset workouts.
- Obtaining operational flexibility by being a smaller unit.

On the other hand, the following problems could arise from using a decentralised approach.

- Increased exposure to losses, say if bank bad debts are concentrated on few debtors or in one sector.
- Limited industry wide coordination – competing for both skilled labour and investor attention.
- No economies of scale in asset valuation, management and disposition.
- Conflicts of interest with the originating bank.
- No central pressure for legal reform and/or special legal powers bestowed upon the AMCs.
- No central channel for government influence including securing funds

On the basis of the above mentioned strengths and weaknesses of the decentralised model, it is evident that the extent to which a decentralised approach will have detrimental effects upon resolving NPLs depends upon: (i) how much the government is willing to empower the AMCs vis-à-vis the judicial system, and (ii) the supporting policies and institutions established by the central government and the SBV.

As for judicial empowerment, experts generally advise to attribute special powers to the Asset Management Company. This includes powers relating to the transfer of loans and collateral and their enforcement as well as procedures relating to registration and transfer of title documents evidencing ownership. A difficult trade-off, however, exists between ensuring that the decentralised AMCs have the necessary power to operate and minimizing the degree of special powers granted to non-legal units. In some countries AMCs have been given powers that exceed what is normally advisable. In Malaysia, for example, the government provided its AMC with extensive authority to circumvent existing bankruptcy laws. In the US following the Savings and Loans Scandal the Resolution Trust Corporation was authorized to override state laws and set aside burdensome contracts. Bestowing such powers to decentralised units is likely to be very difficult politically, and controlling and monitoring such powers to prevent misuse is also likely to represent a major challenge.

As for the above-mentioned supporting institutions that could possibly facilitate the operations of the decentralised AMCs, they could include an overall supervisory institution with the objective of ensuring homogeneous valuations. Experience form Thailand indicates that such institutions help ensure that homogenous NPLs are valued alike across SOCBs and that fire sales of low quality assets are avoided. It is at present not clear whether or not the Vietnamese authorities plan to establish these institutions. If not, it will be difficult to ensure the necessary uniformity and transparency of the NLP valuation, potentially resulting in deterioration of both revenue and public confidence in the process.[32]

Another potentially beneficial supporting institution could be one that coordinated the efforts of the individual AMCs with each other and with the efforts to reform and revitalize the state owned enterprises. It is uncertain whether or not an existing institution could fill this role. In this case, great care would have to be taken in order to ensure that the information given is as objective as possible.

Finally, operational funding for start-up and operations for the individual AMC should be supplied from a non-partisan source – i.e. not from the bank which NPLs the AMC is attempting to resolve. As is evident from the Table 5.10, AMCs in other ASEAN countries derive operational funding from a multitude of different sources, including asset recoveries, issuance of equity, bond programmes and the government.

[32] Similar arguments hold for the decentralized LWUs, where the case for a central coordination of valuation and conditions of sale would appear to be even stronger due to the inherent difficulties associated with resolving non-collaterised loans.

| Table 5.10: Operational funding for AMCs | | | | |
|---|---|---|---|---|
| **Thailand** | **Indonesia** | **Malaysia** | **Korea** | **The Philippines** |
| Government supplied seed capital. The AMC has the ability to issue bonds to purchase assets. Finally, the AMC can issue promissory notes to cover interest expenses | Asset recovery and sale of equity will cover some. Government guaranteed bonds replace acquired NPLs. In return, the state receives equity in the banks. | 75 percent of funding will originate from the AMC Bond Programme. The remainder is funded by loans from the government and SOEs. | 90 percent of funding stems from bonds issued by the AMC. The remaining 10 percent originate from the Central Bank. | Funding is provided by the Department of Finance. |
| Source: Cooke and Foley (2000) | | | | |

The important issue in this context is not the source of funds but the recognition that no central channel for securing funds exists for the decentralised AMCs. Hence, the government has to pay special attention to this issue.

#### 5.5.2.2 The initial assessment and understanding of the problem

As mentioned earlier, one of the most important points emerging from the ADB study of AMCs in East Asia is the need for an initial realistic assessment of the size and character of the problem. The ADB study furthermore points to the fact that addressing the NPL problem does not necessarily imply addressing the factor responsible for creating the problem in the first place.

The groundwork prior to establishing the AMCs will therefore constitute the real test of the government will and ability to undertake in depth reforms of the financial sector. Will the restructuring and re-capitalization of the four major SOCBs imply a change in lending practices? Will bank management autonomy and accountability increase and will SOE favourable treatment come to an end?

These questions should ideally be answered in an AMC strategy formulated by the government. Here the government should consider not only the financial dimension of the problem, but also cultural, political and legal environment. In this context, it is very important that the government clearly and publicly states the objectives and end goals set up for the AMCs. The objectives should support maximum coordination and clarity of governance and provide a yardstick for measuring AMC progress and success.

#### 5.5.2.3 The recruitment and training of skilled personnel

Obtaining and maintaining the necessary managerial and analytical talent is an often-overlooked dimension of institutional change. However, given the fact that the Vietnamese government plans to establish several highly specialized and complex financial institutions in a country where skilled manpower is already in short supply, the approach taken to overcome this problem will be of central importance for the possibilities of achieving government goals.

AMC staff will require expertise in asset management, including asset appraisal, property management, and conducting workouts. In addition, experience in banking, legal matters, accounting, marketing and public relations will also be required. In the short run, the government can perhaps obtain such skills and expertise through outsourcing and/or joint ventures with foreign specialist partners, but this is clearly not a viable or optimal long run solution. To ensure the long-run viability of both the AMCs, the LWUs and the financial sector as a whole the government must therefore accord high priority to initiatives, which build up local analytical and managerial capacity within financial sector issues. This could include:

- Specialized on-the-job and classroom training programmes for people already employed in the sector.
- Supporting the build-up of analytical capacity at external research institutions, departments of economics at universities and analytical institutes.
- Creation of improved incentive structures for financial sector professionals by raising real wages and wage decompression.

The above-mentioned initiatives or a combination hereof can assist the government meet the demand for skilled professionals in the financial sector, but the problem of an excess demand for skilled financial sector professionals is likely to persist to some degree even in the long run.

## 5.6 Concluding Remarks

This chapter has provided description and analysis of some of the key areas related to the further development of the SBV into a fully-fledged modern central bank. It is, however, by far a complete review of the issues that the SBV has to deal with. Other key issues include: SBV performance in the development of refinancing facilities, status and management performance of foreign exchange reserves, level of capitalisation and quality of SBV assets, and procedures for and management of licensing procedures. These are not considered in the present report due constraints imposed by data and time available.

As mentioned in Section 1, the mono-bank history continues to exert considerable influence on both SBV structure and organisation and the degrees of freedom available to pursue SBV objectives. Although the creation of a two-tiered banking system in combination with the legal base provided by the 1998 Law on the State Bank represents considerable progress in the separation of the SBV from the actual financial sector, the persistence and importance of the planning legacy is maintained by the fact that the second process of separation transformation of the SBV – that is, the transformation of the SBV to become an autonomous entity on par with the executive, legislative and judiciary branches of government – is only just beginning to occur.

This was further documented in Section 2 containing an assessment of SBV independence according to three non-substitutable components of independence, namely: legal, political and operational independence. Here it is concluded that the SBV at present cannot effectively develop and execute national monetary policies, as it is still operationally and politically dependent upon support from other government agencies. Hence, although the Law on the State Bank represented a step backwards in terms of restricting stipulated independence compared to the situation prior to the passing of the law it appears more likely that lack of especially political but also operational independence are the more binding constraints.

As a consequence, it is recommended that the pursuit of increased central bank independence in Vietnam should focus on the more indirect route suggested by among others Posen (1994) and Mas (1995). This involves a gradual build-up and strengthening of a non-governmental lobby for an independent central bank. The preliminary plans for the equitisation of the large state-owned banks represent an important step in this direction, as does the continued presence of foreign banks in Vietnam. In this aspect, the current low level of inflation represents an opportunity in terms of creating an environment conducive to increased central bank independence. The reverse causality argument implies that a central bank makes use of low inflation as political leverage. Yet, it is also an obstacle,[33] due to the potential lack of a common cause to unite private sector interest in a lobby for a more independent central bank. Nevertheless, given the prevailing political and economical environment in Vietnam, the indirect approach is likely to be a productive and effective approach in the short- to medium-term. In addition, one should consider complementing the indirect approach with more direct measures directed at limiting local authority interfering in credit institution activities – not the least to improve the overall transparency and predictability of the political interference which takes place.

In terms of the SBV role as a facilitator and organiser of financial markets, Section 5.3 briefly considered the current status on the market for Treasury bills, the inter-bank market for domestic currency, and the domestic market for foreign currency, respectively.

Most importantly, a number of restrictions hampering the further development and growth of the secondary market for Treasury Bills were identified. These included the fact that only T-bills and SBV bills are traded in the market and the fact that the law on the State Bank only allows trade in Treasury bills with maturity of less than a year. Both restrict the development of a sufficiently deep secondary market for government bonds, which again limits the efficacy and power of open-market operations. It was moreover stressed that it is very important that the Vietnamese government carefully considers and balances potential gains and risks related to the possible issue of international bonds. Unless such a decision is thought into a detailed and sequenced plan of financial reforms, the erratic and powerful international financial markets may erase the short-term gains of issuing international bonds.

The central issue focused on in Section 5.4 was whether or not the SBV would gain from the creation of a separate institution responsible for financial sector supervision. The following potential benefits from such a separation were identified:

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[33] Note, that here the prevailing low level of inflation is single-mindedly judged in terms of its relevance to the pursuit of increased central bank independence following the above-mentioned indirect approach.

- The SBV directors and staff will be able to focus efforts and attention on managing money, credit and foreign exchange reserve.

- The separation of the supervisory division from the SBV will serve to increase the distance between the SBV and its former operative functions (the current SOCBs). This will minimize the risk of preferential treatment and/or outsider attempts to bias SBV policies and rulings.

- The narrower set of objectives is likely to make the quest for increased SBV independence easier and more feasible. Less conflict of interest will occur and efforts can be more concentrated.

- The potential conflicts of interest between the overall monetary policies and the supervision of the banking sector will be made more transparent and will have to be settled through discussion and negotiation between the two institutions (i.e. the SBV and a new independent bank supervision institution). This could; for example, be a situation where the bank supervision institution in order to better deal with overdue debt in the banking sector would prefer a more expansionary monetary policy.

The above-mentioned potential gains should be weighed against the operational, political and legal obstacles facing the creation of a new and independent supervisory institution. However, as the process of establishing supervision as an independent unit within the SBV has been underway for some time, the question of whether and when this process is going to stop should be considered.

Finally, Section 5.5 addressed the problem of non-performing loans (NPL) in the banking sector, more specifically the role and use of a new type of institutions in the Vietnamese financial sector, namely asset management companies. Here the following problems related to addressing the NPL problem using the chosen decentralised AMC set-up were identified:

- Deficiencies in key national legal and judicial frameworks such as those concerning collateral, land ownership, transfer of loans and creditor rights, and land usage rights.

- The need to coordinate NPL assessment and restructuring with ongoing SOE reforms. This includes tackling potentially powerful and politically connected debtors who might oppose to the process and/or seek to take advantage of the situation and the relatively ineffective legal recourse.

- The potential benefits from establishing linkages to the ongoing efforts to reform and restructure SOCBs. In this context, a centralised AMC would accord the government with an opportunity to accelerate and guide bank restructuring through, for example, the conditions attached to the purchase of NPLs.

- The scarcity of managerial and analytical talent in the sector. A single entity will be in a better position to reap economies of scale and make the best use of the human capital available.

- The thin or non-existing secondary markets for financial assets make it difficult for separate AMCs to obtain uniform and transparent valuations and conditions of sale. Information is not easily transferred across autonomous decentralised units. In addition, AMC experience in other ASEAN countries have been marred by a lack of interested buyers. A centralised AMC with a more direct government involvement will be in a better position to legitimise the bundling of NPLs and/or to offer discounts if lack of interested buyers also turn out to be a problem in Vietnam.

The limited and fragmented information about the nature and extent of the NPL in the Vietnamese banking system in combination with the fragmented information about the specific conditions under which the AMCs will operate make any predictions about future performance and success rates very difficult. The following three key areas are, however, singled out as areas where increasing government and SBV attention would be beneficial: the autonomy and legal power of the decentralised AMCs, the initial assessment and understanding of the NPL problem, and the recruitment and training of skilled personnel.

# 6 Financial Intermediation vis-à-vis the Agricultural Sector

The purpose of this chapter is to provide an overview of the different economic entities and institutions that are currently active in the Vietnamese financial sector. This includes as well specific problems encountered by the individual types of institutions and their interrelations in the financial market. This overview is provided in Section 6.1, which focuses first on the formal and subsequently on the informal financial institutions. The specific question of allocation of credit between the government controlled and private enterprises is the subject of Section 6.2, while Section 6.3 takes a closer look at financial sector performance vis-à-vis the most important sector in Vietnam in terms of both employment and total output value, namely the agricultural sector. Here special attention will be accorded to the Vietnamese Bank for Agriculture and Rural Development as well as to an evaluation of the degree of competition between the financial institutions serving the agricultural sector. Subsequently Section 6.3 will conclude with an analysis of the effects of interest rate control and the associated lack of savings mobilisation in rural areas. Finally, Section 6.4 presents concluding remarks a summary of the policy implications derived from the analyses.

## 6.1 The Financial Market

Turning first to the formal institutions, one can, for the purpose of identification, define formal institutions as all financial sector entities subject to government legislation and control. While this definition is operational it does not exclude the possibility of formal institutions taking into account both the presence of and competition from informal institutions. Consequently, they can exert considerable influence on decisions and actions taken by formal institutions.

### 6.1.1 Formal Financial Institutions

From Table 6.1 listed it becomes clear that the formal financial sector has undergone rapid growth in recent years in terms of both total deposit volume and total credit volume.

| Table 6.1: Deposits and credit in the formal sector (billion VND) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** |
| **Total deposits** | 7,623 | 13,882 | 16,565 | 18,071 | 24,382 | 33,593 | 41,458 | 56,290 | 74,153 |
| **Total credits** | 5,710 | 10,051 | 15,093 | 23,180 | 33,400 | 42,277 | 50,744 | 62,201 | 72,596 |
| Source: IMF (1999) | | | | | | | | | |

In parallel with the rapid increase in scale, the quantity of services provided by the formal financial institutions has also increased to include various types of financial services, such as investment brokerage, stock brokerage, issuing credit cards, financial consultancy services, asset insurance, and liability insurance.

Listed according to relative size, the formal sector includes the following institutions, which will be considered in turn: state owned commercial banks (SOCBs), joint stock banks (JSBs), foreign banks and joint venture banks (JVBs), People's Credit Funds (PCFs), and Financial Lease Companies (FLCs).

#### 6.1.1.1 State Owned Commercial Banks

There are four large SOCBs in Vietnam: the Foreign Trade Bank of Vietnam (Vietcombank), the Industry and Commerce Bank of Vietnam (Incombank), the Vietnamese Bank for Investment and Development (VBID) and the Vietnam Bank for Agriculture and Rural Development (VBARD). These banks are the leading banks of the banking system and have 230 branches in all cities and provinces in Vietnam. The number of third level-branches nation wide is more than 1,000. The number of staff working for SOCBs is 40,000, of whom the graduate and post graduate workforce accounts for 55 percent, while 43 percent of the workforce has high school graduation as their highest educational attainment. The remaining 2 percent include the unskilled workforce.

As mentioned earlier, the group of SOCBs dominates the credit market. At year-end 1999 outstanding loan volume of these four SOCBs accounted for 73 percent of total amount of loans in the economy. This dominance is mirrored in the mobilisation of funds where the SOCBs accounted for 75 percent of all resources mobilised through formal institutions.

The VBARD is the largest SOCB in terms of legal capital and has a rather wide scope of operations. It serves a wide range of customers and exerts considerable influence upon not only agriculture production but also non-agriculture activities in rural areas. According to a 2000 report by the VBARD, total capital of the Bank was VND 55,041 billion and total debts VND 48,548 billion, of which medium and long-term loans accounted for 42 percent.[34] The VBARD also has extended international relations and foreign businesses, and it has received finance from international financial institutions like ADB, World Bank, and the International Fund for Agricultural Development (IFAD). VBARD has received and implemented 50 foreign development projects amounting to a total investment capital of over USD 1,300 million for agriculture and rural development. In addition, VBARD has carried out credit programmes with broader socio-economic perspective and objectives as stipulated by the government. This includes policy credit for non-commercial purposes like: providing loans to build houses on stilts (over water) in flooded areas of the Mekong river delta and providing loans to reduce the adverse impacts of floods and droughts (this is also considered in Section 6.3, which contains a more detailed description of the VBARD and its operations).

According to the report of 2000 by Incombank, its total assets achieved VND 48,704 billion while total deposit was VND 40,745 billion. Total debts summed to VND 26,224 billion, of which medium and long-term loans accounted for 31.6 percent. Over the year 2000, the Incombank increased the rate of medium and long-term loans from 20 percent at the beginning of the year to 25 percent of total loans at the end of the year. These loans were predominantly granted to large government programmes and priority sectors such as the postal services, the communication sectors, the processing industry, and the production of construction material. In addition, the Incombank has delegated investments and performed credit activities for a range of non-commercial purposes like lending to reduce adverse impacts of floods, the creation of training funds for poor students, and loans to purchase food for reserves.

As for the Vietcombank the 2000 annual report shows that total assets by the end of 2000 was VND 65,633 billion, of which funds in foreign currencies accounted for 74.9 percent. The total volume of deposits at the Vietcombank was VND 43,748 billion, while

[34] According to Article 8 of Decision 1627/2001/QD-NHNN dated 31/12/2001 short-term loans in Vietnam are defined as having a maturity below 12 months. As for the medium-term loans their maturity ranges from 12 to 60 months, while long-term loans are defined as those having a maturity above 60 months.

total credit lending was VND 14,421 billion, of which medium and long-term loans accounted for 17.61 percent[35]. A total of 57.8 percent of total loan volume was in VND.

As for the Vietnamese Bank for Investment and Development, the 1999 annual report indicates that its total assets amounted to VND 39,176 billion, of which total loans accounted for VND 28,201 billion.[36] Total deposit volume amounted to VND 18,379 billion in 1999. In addition to undertaking the functions of a multi-functional commercial bank, VBID was responsible for assisting government directed development investments. In 1999, the government granted the Bank a development investment credit worth VND 8,335 billion. This fund was especially allocated to several big economic programmes directed towards industrialisation and modernization, including programmes to develop electricity, petroleum, cement, and rubber industries, or programmes directed towards industries processing agricultural outputs such as sugar cane and seafood.

Hence, as indicated above a considerable degree of government involvement in the allocation of credit can be detected in all four large SOCBs, which have all been required to undertake non-commercial and/or development oriented programmes. This will be looked into in more detail in Section 6.2.

#### 6.1.1.2 Joint Stock Banks

There are a total of 47 joint stock commercial banks (JSBs) in Vietnam. Thirty-one are urban JSBs and the remaining 16 are rural JSBs. The majority of the JSBs were established rapidly in the years following the initial liberalisation of the financial sector. Their rapid establishment at a time where the pace and direction of the market-reforms were still unclear can perhaps in part explain why they have subsequently run into problems.

When the magnitude and nature of the problems in the JSB sector became clear in the second half of the 1990s, the government undertook independent diagnostic audits of all the JSBs during 1998-1999. On the basis of these audits, the JSBs were subsequently classified into four types and a restructuring strategy for each type was developed. Government follow up on these strategies has so far led to the rehabilitation of viable banks and the merger or closure of weak banks. Three JSBs have already been closed, two have been merged and 13 have been put under increased surveillance. In addition, it

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[35] This was lower than the share of medium- and long-term achieved in both 1998 and 1999.

[36] Medium and long-term debts accounted for 61 percent total credit from the Vietnamese Bank for Investment and Development.

has been announced that another nine JSBs will, most likely, be closed in the immediate future.

#### 6.1.1.3 Foreign Banks and Joint Venture Banks

There are 15 branches of foreign banks and four joint-venture banks (JVBs).[37] In addition, there are 62 representative offices from 20 nations operating in Vietnam. They include major international banks such as Deutsche Bank (Germany), Bank of America and CitiBank (USA), Standard Chartered (Great Britain) Credit Lyonnaise (France), ANZ Bank (Australia), State Bank of Krung Thai Bank (Thailand), and National Bank of Kuwait (Kuwait).

Since their establishment, the market share of foreign bank branches has increased sharply. In the deposit market, the market share of foreign banks has increased 9.2 times from 2 percent in 1994 to 18.5 percent in 1997. Following the East Asian Financial Crisis the market share has, however, decreased slightly to holding 14.7 percent of all deposits in 1999. A similar pattern can be found on the market for credit where the market share of foreign banks first increased approximately 14.6 times from 2 percent in 1994 to 29.2 percent in 1998, only to be followed by a slight reduction to 25.7 percent in 1999. As will become clear below, the existing, however, still blocks foreign banks from becoming fully fledged participants on the Vietnamese financial market. Hence, despite recent progress the Vietnamese government has yet to establish a level playing field for competition between foreign and domestic banks.

#### 6.1.1.4 People's Credit Funds

As mentioned in Section 3.1 the system of People's Credit Funds was established in 1993 to replace the system of credit cooperatives that virtually disappeared following a general loss of depositor confidence that led to bank runs and resulting problems of repayment during 1990-91. More formally the Prime ministerial Decision 390/TTg dated 27/07/1993 permitted the pilot establishment of PCF system. At the end of 1999, a total of 971 Local Credit Funds (LCFs) existed in communes and districts with a total of 714,000 members.

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[37] These include joint ventures between Vietnam and Malaysia, between Vietnam and Korea, between Vietnam and Indonesia, and between Vietnam and Thailand.

As stated in Section 3.1, the intention underlying the creation of the system of PCFs was to create a three-layer organization in order to achieve a combination of close local contacts and connections while minimizing the risks associated with seasonality and regional shocks. As a consequence, all LCFs were handled and directed by Regional Credit Funds (RCFs), which in turn would be supervised by the Central Credit Fund (CCF) handling the supply and balancing of liquidity among the regional funds.

Current status is that 21 RCFs exist on the regional level, which in turn all are members of The Central PCF.[38] At the end of October of 1999, after approximately six six years of operation, the LCFs had mobilised a total of 2,220 billion VND in deposits, of which 157 billion VND was capital put up by founding members and the remaining amount was mobilized funds. The total value of outstanding loans was 1,816 billion VND of which 4.14 percent is over-due debt. Hence, compared to commercial banks, deposit and credit market shares of the PCF system are relatively small amounting to only about 1-2 percent of total market volumes. The operational performance of the RCFs was quite good, meeting members demand for capital and mobilising about 400 billion VND annually. Section 6.3 will, however, focus on some of the problems facing the PCF system in terms of meeting the demand for financial services in the rural markets.

#### 6.1.1.5 Financial Lease Companies

Financial lease companies are a relatively new institution on the Vietnamese financial market, performing medium and long term credit activities by leasing machines, equipment, transport means and others types of capital to manufacturers. In short, the financial lease companies buy machines according to the requirements of a leasing party (i.e. a manufacturer), which subsequently uses and leases according to a specified contract, which cannot be cancelled before time. At the termination of contract, the leasing party has to choose between using their option and right to buy the equipment or to continue to hire it according to conditions as specified in a new contract.

From October 1995 when the government issued Decree 64/CP stipulating the statute on organization and operation of financial companies as well as the State Bank of Vietnam (SBV) promulgated circular 03/TT-NH from February 1996 to now, the SBV has granted

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[38] In the regions where no RCFs exist, any existing local PCFs are also members of the Central People's Credit Fund.

the license to nine financial companies, including two joint stock companies, two that are fully financed by foreign capital, and five companies that are owned directly by the SOCBs.

The FLCs have, however, only gradually become an accepted alternative by enterprises. This explains that the total amount of capital channelled through FLCs loans only accounted for 1 percent of total commercial bank credit by the end of 2000.

### 6.1.2 Informal Financial Institutions

As informal financial markets and institutions were repressed during the central planning period very little information about informal finance during this period exists. This has improved since 1989, where the gradual transition towards increased reliance on market forces has implied a parallel rise in the acknowledgement of and recognition bestowed upon the informal financial sector. The unregulated and at times illegal activities taking place in this sector, however, still imply that neither comprehensive nor fully reliable data exist on the magnitude and character of the informal institutions and transactions in Vietnam.

The following informal credit institutions are described below: Moneylenders, tontines (rotating credit and savings associations), loans from relatives and friends (mutual lending), and trader credit.

#### 6.1.2.1 Moneylenders

Generally, moneylenders are wealthy individuals, who on lend their funds and/or funds borrowed from other sources. Their clients are households who need short-term capital for production purposes and poor household who need money to cope with emergencies. The necessary procedures to obtain a loan are very simple, usually just a piece of paper stipulating the contract agreed upon by moneylender and the client. In some cases, no paper exists, so the parties rely on oral agreements, only.

Loans can be made in both cash and kind, and the specific terms of the contract such as interest rate and duration depend on the relationship between lender and borrower. A recent survey by Sy (1999) indicates that while the average interest rate of money loans was 5 percent per month, some households were able to obtain loans at 1.8 to 2.5 percent per month, while a few had to suffer loans with interest rates as high as 6 percent per month. Overall, if the loan is in cash, surveys have found that the interest rate level is between two to five times higher than that of formal credit. The duration of the loan is typically short, measured in weeks or months and only rarely exceeding a full year. The loans in kind are especially popular in rural areas, where a poor household is provided with foodstuff or seed by the lender, who in turns demands, a repayment in cash or rice.

#### 6.1.2.2 Tontines (Roscas)

A tontine (also known as a Rotating Savings and Credit Association or Rosca) is an informal financial institution found in almost all regions of the world. A Rosca usually consists of a group of people, who are voluntarily or involuntarily excluded from the formal financial system. The group meets on a regular basis all bringing a pre-determined amount, which subsequently is put into a Rosca pool. Through recurrent meetings this pool is sequentially allocated once to every group member. After having received the pool, members have to continue to contribute to the Rosca until every member has received it once.

The objective of a Rosca is often twofold: (i) to obtain economies of scale by pooling the collective savings of the group, and (ii) to provide external incentives to save through the obligation to the Rosca group. This second motive is intrinsically linked to issues of intra-household allocation of resources through the fact that the majority of Roscas are typically all-female groups. The primary advantage of joining a Rosca is that all but one member (the one who receives the pool in the last round) will obtain funds faster than if she had chosen to save on her own. The primary challenge facing Rosca participants is likewise twofold: (i) to ensure member compliance such that they continue to contribute to the Rosca after having received the pool, and (ii) to determine how to allocate the pool in each round. While Rosca members usually rely on a combination of informal sanctions/reputation effects and the limited mobility of Rosca members to deal with the problem of compliance, the problem of allocating the pool is essentially a choice between different types of Roscas. They include: (i) a random Rosca (where the pool is allocated through a lottery between the eligible members - i.e. those who have yet to receive the pool); (ii) a bidding Rosca (where the pool is allocated through sequential auctions in which each eligible member states the maximum reduction in the contribution of the other eligible members contribution she is prepared to accept); and (iii) a discrete Rosca (where the pool is allocated according to a discretionary criteria that may change from round to round – usually the person who organised/founded the Rosca is the one who takes the decision).

Anecdotal evidence points to the presence of at least two types of Roscas in Vietnam: commercial (bidding) Roscas and family based (random or discrete) Roscas. A professional Rosca organiser who has the assets and prestige necessary to make potential members believe in and trust the Rosca usually founds the former. The organiser (sometimes in cooperation with the participants) proposes the rules of Roscas such as the amount of capital (typically in cash) that should be contributed in each round, and the interval between meetings (days, weeks or months). More often than not, the organiser and the participants do not know each other in advance, making the participation in such a Rosca a bit of a gamble for all parties. No guarantees exist that the founder or individual participant does not run away/fail to make payments. As a consequence, the implicit interest rate levels that can be calculated from the winning bids in each round are found to be quite high – typically 50-300 percent higher than that what can be obtained in commercial banks.

In the family based Rosca all participants are, as indicated by its name, acquainted with one another by being relatives or friends. One of them is chosen to be the organiser, but all members typically agree upon the rules and terms. The member, who is to receive the pool in a given round, is either selected by lot or by common agreement – typically based on an intra-group comparison of individual member's perceived need for the pool. The organiser is responsible for the implementation of the Rosca and will typically collect member contributions in each round. These are duties and responsibilities for which she almost always receives the pool in the first round. This type of Rosca usually has contributions in the form of rice and/or money.

Based on the aforementioned anecdotal evidence, the observed pattern where random and discrete Roscas appear in predominantly rural and traditional settings while bidding Roscas appear in more market-based, modern environments lend support to the hypotheses originally proposed by Clifford Geertz. According to Geertz (1962) the choice between different types of Roscas reflects a gradual process of modernisation where the eventual dominance of the market-based relationships will lead to the demise of the random and discrete Roscas. This is, however, in contrast with later theories put forward by Ardener (1965) and Besley et al. (1992) where the choice between different types of Roscas rather reflects special characteristics of the group and the environment in which they operate.[39]

[39] The notion that the choice of Rosca depends not only on group characteristics but also on the environment in which they operate is found in Kovsted and Lyk-Jensen (2000).

One could speculate as to whether the recent re-orientation towards market-based principles in Vietnam have caused people to perceive these as being more modern and more advanced than traditional mechanisms. If so, this perception could bias Rosca participants, who are aware of all the mechanisms available, to choose the more market-based mechanism as it is *perceived* to be more effective under all circumstances.[40] More research into this area is, however, needed if one is to make more definitive statements concerning this issue.

#### 6.1.2.3 Loans from Friends and Relatives

As stated previously, this form of credit is probably the most important source of credit for households, expressing not only differences in wealth and access to credit but also family links and the strength of neighbour relations. A loan is typically provided if a household suffers from difficulties due to e.g. disease or floods, or if a household is facing a major event such as a wedding or building a house. This kind of financial assistance is given without incurring interest payments.

It is, however, not only households, which rely on this type of credit. A survey of 407 enterprises in Ha Noi, Hai Phong, Hai Hung, Song Be and Ho Chi Minh City was conducted in 1996 by Dr. Tran Kim Hao and a research group of the Central Institute for Economic and Management (Hao et al. 1996). They revealed that 46.5 percent of all surveyed enterprises accessed loans, of which 35 percent borrowed from relatives and friends to establish their enterprise.

#### 6.1.2.4 Credit Sales

Private lending is essentially deference on payments for goods delivered. Suppliers selling on credit are the lenders and the buyers are the borrowers. Lending procedures are simple. Lenders give the goods to the borrowers when they sign in the ‘debt’ book of lenders. The duration of a loan is typically a production and/or business period, while the interest level typically depends on the price of the goods delivered, ranging from 0 percent to 5 percent per month.

[40] Looking at existing economic models it, however, becomes clear that a bidding Rosca is not always the preferred choice if using an ex ante evaluation of the expected outcomes of a bidding versus a random Rosca.

### 6.1.3 Informal Credit

The 1993 Vietnamese Living Standards Survey (VLSS) provides some indications of the importance of informal finance. Here it was found that 73 percent of all households used informal credit. It was moreover found that funds from family members, relatives, friends and neighbours supplied up to 40 percent of the credit to private households. Another third of the credit was supplied by moneylenders while only a quarter of total household credit originated from formal banks and other sources. The Vietnam-Sweden Mountain Rural Development Programme (1999) provides similar estimates as to the importance of informal credit – here it was found that more than 50 percent of households surveyed in the northern mountainous provinces included in the programme had no access to formal credit and consequently had to rely on informal credit. In general, lack of assets or land-use-rights required by commercial banks as collateral and/or lack of basic knowledge of how the formal financial system operates are among the major constraints faced by poor seeking to obtain credit. This is so when they need credit for investments in productive capital and when they face an urgent need for funds. This may happen for example if a family member falls ill, in times of flooding, and when weddings or funerals are faced. In these situations poor households rely on the informal financial market.

In this context it is, however, important to understand that the informal sector far from always represents the second-best complementary option compared to the formal sector. In many cases, the services and products offered by the informal sector are perceived as being superior to choose offered by the formal sector. This could be due to lower interest rates (for example credit obtained from family and friends) or due to lower transaction costs (through more rapid dispersion of credit and/or less paperwork) or both. Dat (1998) provides an example of lower transaction cost in the informal sector on the basis of a study of 150 rural households in the Red River Delta in 1996. Here it was found that while mean amount borrower transactions costs in the formal Vietnamese institutions compared favourably with borrower transaction costs in other Asian countries, those incurred by applicants for small loans were quite high in Vietnam. In particular, it was found that for loans under VND 1 million the higher transaction costs associated with formal loans in effect outweighed the higher interest rates paid for such loans in the informal sector. The very poor applying for small loans would thus be better off by using the informal financial sector.

However, often households borrow from both the informal and the formal sector. Recent research on a rural credit market in Gia Lam district of Hanoi City surveyed 216 households, of these 121 households (amounting to 56 percent) had taken up loans, and 98 of those who did had used informal credit sources (amounting to a total of 45.3

percent of all surveyed household). The interest rate charged ranged from being 1.5 to 3 times higher than on the formal market[41] and in addition, the size of the informal loans was smaller than those received on the formal market where loans typically range from several hundred thousands to several millions VND.

It would, however, be wrong to assume that the informal financial sector only provides services to households. A field-study in the Quang Nam Province indicates that a majority of the 94 shrimp ponds surveyed have used the informal sector as an important source of credit. Establishing shrimp ponds is a capital-intensive industry, where initial investments are as high as hundreds of million VND. This is especially the case when having intensive and semi-intensive shrimp farming on sandy areas, as is the case in the Quang Nam Province. The shrimp farmers can only rarely count on raising the entire amount needed for the initial investments plus the 8-10 million VND needed for purchasing inputs from the formal sector. Consequently most of the shrimp farmers complement formal loans with informal ones.

Thus, informal credit is also an important source of credit for enterprises. It is especially small and medium sized enterprises (SMEs) which, in addition to the funds they can accumulate on their own, use informal credit sources help mobilize capital in start-up and development phase. SMEs use the informal market due to less demanding (in terms of capital and assets owned) requirements to obtain a loan (relying essentially on trust), the more simple procedures (written or oral agreements), and the specific nature of their planned enterprise, which may not be sufficiently recognised by the formal financial institutions.

In short, the informal sector can be both complementary or a substitute to the formal sector. Accordingly, the formal sector must take both the presence and the reactions of the informal sector into account when designing and offering financial products and services.

## 6.2 Formal Sector Credit Allocation

To some extent the question of whether and by how much the government is able to continue to influence the allocation of credit reflects how far the transition from a

[41] Note that this is actually illegal according to Article 473 of the Civil Code. Here it is stipulated that the maximum interest rate on informal loans must not exceed 1.5 times that which can be obtained in the formal market. This law is, however, not enforced and it is indeed difficult to see how it can ever be given the very nature of the informal market.

centrally planned economy to more market based economy has progressed in Vietnam. In this context it is, however, important to realise that central planners rarely have all the information necessary to completely plan for and coordinate an entire economy. As pointed out by Appold and Phong (2001) central planning committees and ministries are likely to have functioned as the 'locus of negotiation and bargaining between the state and its economic agents, the state owned enterprises'. In other words, when assessing whether or not the government continues to influence the allocation of credit to government controlled agents, one has to evaluate to which extent and on which terms the government owned bank enter the centrally coordinated negotiations and bargaining sessions. Given the comprehensive government control of certain sectors and industries such interaction still takes place in Vietnam.

The final decisions on control of credit allocation are more likely to originate from a series of meetings and bargains than from a centrally placed command and control centre. Thus, it is unlikely that very detailed plans stipulating all terms and conditions for any government controlled allocation of credit can be found. This is so even in the (unlikely) case where all government processes and decisions are fully transparent. The fact that credible information is both scattered and sparse in Vietnam (see Section 4.5 on accounting standards and information possessing) only adds to the difficulties involved with getting an accurate assessment of the nature and degree of direct government control of the allocation of credit. Accordingly, an assessment of this nature can only be tentative, relying on indirect measures and the detection of indicative patterns.

### 6.2.1 Issues Related to Government Control of Credit Allocation

In the process of transforming a formerly centrally coordinated system to a market-based system, the timing of the transfer of government ownership (the equitisation process), on the one side, and the relationship between the SOBs and the SOEs, on the other, determine where and how the government (if it desires to do so) can continue a policy of subsidising the state-owned enterprises. Table 6.2 presents the four different outcomes in a simplified representation of this argument:

| Table 6.2: Objective of SOBs and credit allocation to SOEs | | |
|---|---|---|
| | Allocation of credit to SOEs is market-based | Allocation of credit to SOEs is determined by government |
| Top priority of former state-owned but now private banks is to maximise profits | **4** | **3** |
| Profit maximisation is not the top priority of the SOBs | **2** | **1** |

Outcome 1 in Table 6.2 more or less represents the situation in Vietnam prior to the initiation of the Doi Moi reforms. The overall objective of the SOBs was to function as a supplier of credit to the SOEs – i.e. to be subservient to SOEs. Consequently, maximisation of SOB profit was not a priority objective if at all on the list of priorities. The SOEs were the focus of government economic policies and planning, and the government consequently controlled allocations of credit to the SOEs in accordance with these plans and objectives.

At the other end, outcome 4 to some extent reflects the current situation in OECD countries. State-owned enterprises can, of course, still apply for credit in (the often formerly) state-owned banks, but given that the first priority of the SOBs is to maximise profits, any decision to grant credit to SOEs will be made based on a market-based assessment of expected profits and risks associated with their application. To obtain this degree of bank autonomy vis-à-vis SOEs typically requires that the SOBs are sold to private owners through a process of equitisation.

Outcomes 2 and 3 represent intermediate stages in the transition from outcome 1 to outcome 4. In outcome 2, the SOBs are still not allowed to assign top priority to profit maximisation but the allocation of credit to SOBs is conducted according to market principles. Hence, while SOBs might be forced to extend loans to SOEs they will (in principle)[42] receive compensation for doing this from the government. Consequently, any subsidies and favourable treatment that the government might wish to extend to the SOEs will come from and appear on central government budgets. This (potentially) has the benefit of enhancing overall transparency concerning the extent and nature of government subsidies to the SOBs.

Outcome 3 represents another quite different situation. Here the SOBs are allowed to pursue an overall objective of profit maximisation vis-à-vis their non-government customers while the government reserves the right to stipulate the terms and conditions under which the SOEs receive credit. In this outcome the government transforms bank profits made on private customers into subsidies to the SOEs. As a consequence, any direct subsidies given to SOEs over the state budget can be reduced by the indirect subsidies channelled through the SOBs and financed by the SOB private customers. In addition, the extent and nature of subsidies given to the SOBs are less transparent to both outsiders and to the government itself.[43]

The transformation from outcome 1 to 4 is a prolonged and gradual process rather than a clear structural break. Moreover, the timing between the process of increasing SOB autonomy (the equitisation process) and the process of reforming the principles and procedures governing the allocation of credit to the SOEs is likely to be neither perfect nor coordinated. On this background, it makes sense to compare and evaluate outcomes 2 and 3.

First, it should be noted that Outcome 2 is clearly preferable to Outcome 3 in terms of overall transparency of the character and magnitude of subsidising SOEs. This is the case for both the central government that achieves better and more precise information, which can be used to improve and reform existing polices, and non-governmental, external agencies, which (if allowed by the government) can obtain a better assessment of the overall state of the economy and the financial sector in particular. Second, it is clear that Outcome 3 becomes increasingly non-sustainable if the process of equitisation lead to a gradual increase in the private ownership of banks. It is thus evident that an inherent tension exists between increasing the level of SOB autonomy, on the one side, and the government wishing to continue to influence the allocation of credit to the SOEs, on the

[42] The SOBs will not be fully compensated to the extendt that stipulated extension of credit to SOEs might limit the SOBs possibilities to pursue more profitable projects in the private sector due to, for example, reserve requirements and/or a limited supply of credit available.

[43] Note that this might represent a serious short-term problem if this is inclined to abolish the practice of subsidising the SOEs.

other. In conclusion, Outcome 2 is the preferred intermediate stage between a centrally coordinated economy and a market-based system, consisting of fully autonomous economic entities.

Vietnam has already launched a process of equitisation with the stated objective to fully privatise the SOBs (see Chapter 3). Thus, one objective of the subsequent analysis in this chapter is to assess the degree to which SOBs receive market-based compensation for allocating credit (directly to SOEs or to government programmes) according to government directives. This will give an indication of the nature of future tensions that are likely to arise in the process of transforming the Vietnamese financial sector.

### 6.2.2 Analysing Issues Related to the SOCB Allocation of Credit

Prior to assessing the allocation of credit to private and state-owned enterprises it will be useful to:

1. Compare the development of the two sectors in recent years in order to assess their respective demand for credit.
2. Evaluate whether the legislative system puts the two sectors at par with respect to access to credit.
3. Assess the extent to which the government uses the SOCBs as partners and contributors of capital in the implementation of special (non-SOE) programmes.

Subsequently the analysis will turn to consider actual disbursement of credit between the two sectors.

#### 6.2.2.1 Recent Developments in the Private and State-Owned Sectors

The private sector in Vietnam has increased rapidly since the initiation of the Doi Moi reforms. By September 2001 there were 66,780 registered enterprises throughout the country. Some 58 percent were private enterprises, 38 percent were limited liability companies, 3 percent were shareholding companies, and less than 1 percent were partnership companies.

With the issuance of the Enterprise Law that came into effect from January 2000, it is forecasted that the number of private enterprises, limited liability, and shareholding companies will triple their numbers by 2005. The number of business households in urban areas is predicted to increase by more than 20 percent a year, while commercial farms and manufacturing households in rural areas are expected to increase by more than 5 percent a year

In contrast, the number of SOEs has decreased by over 50 percent from 12,300 enterprises to 5,789 enterprises over the past 10 years. This rapid decline was caused by a combination of liquidations, bankruptcies, mergers, equitisation, and the sale of state-owned companies to the private sector. The forecast for the coming years is that the number of SOEs is expected to decrease by 50 percent over the period 2000-2005 and by 30 - 35 percent over the period 2005-2005 before levelling off just below 2,000 SOEs. The Vietnamese government is thus determined to maintain ownership of SOEs in important areas of the economic infrastructure including electricity, petroleum, postal services, communication, airlines, and the shipyard industry. Hence, despite the overall reduction in the number of SOEs since the initiation of the reforms, the mere fact that the governments intends to maintain ownership of these capital intensive industries imply that the demand for credit by state-owned enterprises is unlikely to decrease and might even increase over the next 5-10 years.

#### 6.2.2.2 Legal Constraints on Private Sector Access to the Banking System

According to the policy of economic development of the Vietnamese State every sector private and government has, in principle, been accorded equal right to pursue their business activities. Although not the result of a comprehensive survey of the entire existing body of legislation, the following are examples of areas and issues where the current legislation in effect discriminates against private enterprises:

1. Decision 423/2000/QD-NHNNI by the State Bank dated 22/09/2000 on the credit policy of banks towards farming activities stipulate that the head of a farm household can borrow up to 20 million VND without collateral. Although this has been gradually loosened over recent years,[44] problems still occur as the farm develops and consequently needs to raise additional capital. In this case the

[44] Prior to 1999 households in rural areas could only borrow up to five million VND without mortgage. This was increased to ten million VND in March 1999, while the current maximum of 20 million VND came into effect in September of 2000. Aquaculture households can, however, borrow up to 50 million VND without mortgage.

household is confronted with Decree 178/1999/ND-CP on credit guarantee. More specifically, Clause 2, Article 15 of this Decree requires that assets created through previous extensions of credit have to be valued in order to serve as collateral for the new loan. This is, however, not without problems if the assets are fruit gardens or fields of industrial crops. Banks typically lack the skills and tools required to accurately assess the value of such assets. This in turn causes the banks to be reluctant to lend to these types of enterprises, which in turn restrict their opportunities to grow and/or force them to consult higher priced informal sources of credit.

2. Another problem associated with Decree 178 occurs when cooperatives in rural and mountainous areas approach the formal system for credit. As the modes of production employed by these cooperatives are typically labour rather than capital, they often lack the assets required to obtain credit. In addition, Article 14 of this Decree only permits enterprises to borrow if they can present medium to long-term projects, which the cooperatives typically have, difficulties in doing. A final option stipulated in Article 20 of Decree 178 would be to borrow on trust (vay tyn chep), but this requires that the customers can establish that they have had positive profits in the last two years (Clause 2, Article 20) leading up to their application for credit. This requirement is often very difficult for cooperatives and small enterprises to satisfy.

3. Article 20, Decree 178 and Section 1, Chapter IV of Circular 06/2000/TT-NHNNI stipulate that customers who lack the required assets to obtain a loan must provide a plan of the investment project, which established that they are capable of repaying their debt or have projects in accordance with regulations by the SBV. However, SOCBs are typically very reluctant to finance small scale enterprises due to their perceived lack of prestige and the limited skills possessed by SOCBs in these areas Thus, SOCB credit to small and medium sized enterprises will typically only be given when the proposed project, in accordance with SBV regulations, have a guarantee issued by a social institution.

4. Clause 3, Article 5 of Circular 06/2000/TT- NHNNI stipulates that an asset which is to be used as a guarantee must be owned by the legal entity which requests and signs for the loan. This, however, may represent a problem for the owners of small enterprises, who might have a personal savings account. Under Decree 176/1999/ND-CP on registry fee and improved competitiveness and Decree 08/2000/ND- CP on guarantee transaction, such accounts cannot be registered as owned by their company. As a consequence a personal savings account cannot be

registered and counted as a guarantee for loans. This implies that the savings patterns of households and individuals, who frequently use their own funds for business purposes, are not taken into account.

The Government is currently conducting a revision of Decree 178 on credit guarantees with the intent of making it more flexible towards private sector behaviour and preferences. However, the examples cited above make it clear that the current legislation is not always designed with the specific characteristics and constraints of small and medium sized enterprises in mind.

Additional examples of other areas where recent measures seek to reduce preferential treatment given to SOEs in the financial system include: Instruction 417 addressing the collateral requirements for loans to SOEs, Circular No. 3 on the write-off and rescheduling of non-performing loans to SOEs, and Instruction No. 9 on the extension of maturity of loans at risk. In addition, the government has agreed to further level the playing field for foreign banks by allowing them to offer foreign currency deposits and lending to exporters.

#### 6.2.2.3 SOCBs in the National Target Programmes

A National Target Programme is a long-term (5-20 years) governmental programme implemented to achieve one or several broader developmental objectives. According to Article 2, Decision 42/2002/QD-TTg, March 2002 a National Target Programme is "A project within a national program is understood as a project consisting of a range of activities, which will be conducted in order to reach one or more specific targets clearly defined in the program with already determined resources and timing".

Prior to 1998 there was a total of 21 concurrent National Target Programmes, but Decision No.05/1998/QD-TTg in 1999 cut the number of National Target Programmes to seven. In May 2001, the government issued Decision No71/ 2001/ QD-TTg, which approved the following seven National Target Programmes for the 2001- 2005 period:

- Programme on the elimination of hunger. The objective is to reduce the percent of poor households to below 10 percent of all households in part by providing basic infrastructures to poor communes. This includes creating jobs for 1.4 – 1.5 million people per year.

- Programme on population and family planning. The objective is to reduce the annual population growth rate to 1.16 percent by 2005.

- Programme on the prevention of epidemic diseases such as HIV/AIDS.
- Programme of Culture aimed at preserving and developing cultural values with a symbolic value to the nation.
- Programme on education and training
- Programme on providing pure water and environmental cleaning up in rural areas.

Over the period 1998 – 2002, a total of 20,892 billion VND was invested in the seven National Target Programmes. Of these 9,316 billion VND (approximately 45 percent) was financed over the state budget. A total of 5,080 billion VND (approximately 24 percent) was financed through credit extended by the banking sector, while 3,516 billion VND (or 17.1 percent) was mobilised through non-bank domestic sources such as mass organisations.

In addition, the National Target Programmes operate according to special mechanisms and rules in terms of both mobilisation and allocation of resources within the banking sector. As a consequence, the National Target Programmes directly stipulate the terms and conditions under which the target population and institutions can access credit from the banks used to implement the Programmes. These banks include the Vietnamese Bank for Agriculture and Rural Development, the Bank for the Poor, and the People's Credit Fund. Information on the terms and conditions of the credit extended by the banking sector to the government is, however, not available. This makes it impossible to identify with certainty whether a surplus generated in the SOCBs is in fact being used to finance the seven National Target Programmes.

Based on the information in Sections 6.2.2.1 to 6.2.2.3 we can thus conclude, that:

- The private sector demand for credit is likely to have outgrown that of the state-owned enterprises over the last decade. However, the demand for credit by state-owned enterprises is unlikely to decrease further over the coming years as the government intends to maintain control of a large number of capital-intensive enterprises. In this context it is important to note that the final allocation of credit between the private and the state-owned enterprises depends not only on their respective demand for credit but also on the attractiveness and strength of their applications for credit, and not least the criteria used by the banks to decide upon credit allocation.
- Although the overall principle of the government is to secure equal access to credit to all sectors and enterprises regardless of ownership, a brief review of

selected issues has indicated that especially the access of small to medium sized private enterprises is restricted by the current legislation. If one adds to this the anecdotal evidence suggesting a bias against private sector applications for credit among SOCB staff, the likely result is increased demand for informal finance among private enterprises and/or a lower rate of growth in the private sector.

- The existence of large National Target Programmes, which are in part financed through credit extended by the banking sector, is likely to reduce the overall amount of credit available. Whether or not these programmes also receive an indirect subsidy through terms and conditions under which the government have access to these funds is unclear given the present evidence.

These observations will have to be kept in mind, when we subsequently turn to look at the data on actual allocation of credit by the banking sector.

### 6.2.3 SOCB Allocation of Credit

Figure 6.1 indicates that the credit ratio of the private sector has been increasing rapidly from below 10 percent in 1990 to nearly 30 percent in 1998. The drop from just above 40 percent in 1996, i.e. the year before the East Asian Financial Crisis, can also be noted.

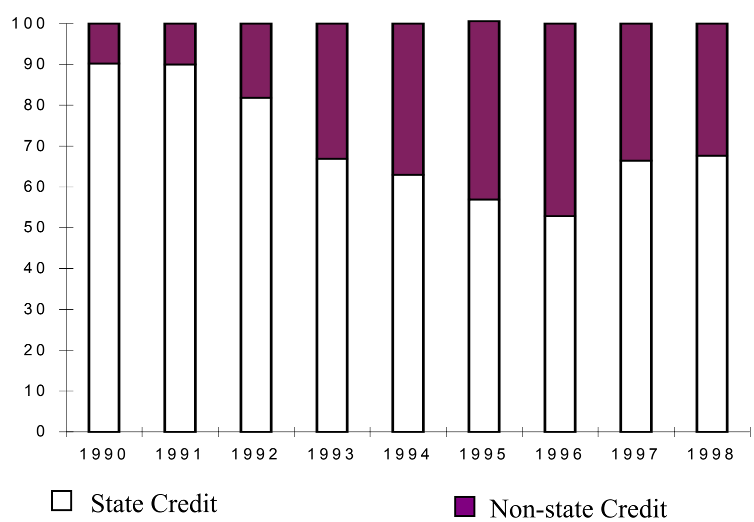


**Figure 6.1: Credit to state- and non-state owned enterprises (shares in percent)**

Source: IMF (1999)

As depicted in Table 6.3, a similar pattern and development is found when looking at the ratio of credit in foreign currency.

| **Table 6.3: Foreign currency credit to state and non-state enterprises (shares in percent)** | | | | | |
|---|---|---|---|---|---|
| | **1994** | **1995** | **1996** | **1997** | **1998** |
| **SOEs** | 81.7 | 76.3 | 75.8 | 78.8 | 72.2 |
| **Private sector** | 18.3 | 23.7 | 24.2 | 21.2 | 27.8 |
| **Of which:** | | | | | |
| **Cooperatives** | 0.2 | 0.2 | 0.3 | 0.1 | 0.1 |
| **Shareholding and limited liability companies** | 7.7 | 9.8 | 7.4 | 12.1 | 10.8 |
| **Joint-venture and foreign-invested companies** | 4.7 | 11.4 | 14.5 | 17.1 | 15.0 |
| **Individuals, households** | 6.2 | 2.2 | 2.0 | 1.9 | 1.9 |
| Source: IMF (1999) | | | | | |

Table 6.3 shows that the overall increase in the share of credit in foreign currency which is allocated to the private sector is not universal across the different entities that make up the private sector. Hence, while credit to joint-ventures and foreign invested companies have almost quadrupled over the relatively short period, the credit allocated to individuals and households have been reduced to below a third of its 1994 level.

Moreover, although the ratio of banking credit of the private sector has increased considerably from 1990, the above analysis has indicated that difficulties and obstacles still restrict private enterprise access to capital from the SOCBs. In this context, Table 6.4 documents that the SOCB ratio of state and non-state credit differs substantially from that of the JSBs. This suggests that some degree of exclusion of private enterprises might be taking place.

| Table 6.4: Lending to non-state institutions (share in percent of total lending) | | | | | |
|---|---|---|---|---|---|
| | **1994** | **1995** | **1996** | **1997** | **1998** |
| JSBs | 58.2 | 62.6 | 61.5 | 67.5 | 71.4 |
| SOCBs | 32.6 | 74.0 | 42.5 | 44.6 | 42.1 |
| Source: IMF (1999) | | | | | |

The SOCBs enjoy advantages of lower input costs as well as high volume and extensive branch networks. The restrictions on private sector access to these banks therefore represent a significant disadvantage compared to more privileged state-owned enterprises. In 2001, the total value of credit issued was VND 218,900 billion, of which medium and long-term credit (i.e. with a maturity that exceeds one year) only accounted for 37 percent. The majority of the medium- and long-credit was, however, directed to State investment projects of high priority resulting in a shortage of this type of credit to the private sector.

Among the SOCBs it is mainly the Vietcombank and the VBARD, which lend to private enterprises. The reason is that these two banks have an extensive branch network at the district and village levels. Moreover, the respective areas of specialisation, which to a large extent date back to what was stipulated during the mono-bank era, are in sectors, which have seen rapid growth following the initiation of the Doi Moi reforms.

In conclusion, returning briefly to the typology of outcomes presented in Table 6.2, it would appear that Vietnam has opted for outcome 3 rather than outcome 2 as the intermediate stage between a centrally coordinated to a market-based (in effect decentralised) economy.

As mentioned previously, opting for outcome 3 implies that while the SOBs are allowed to pursue an overall objective of profit maximisation vis-à-vis their non-government customers, the government still reserves the right to stipulate the terms and conditions under which the SOEs receive credit. This in effect amounts to the government transforming bank profits made on private customers into subsidies to the SOEs. As a consequence, any direct subsidies given to SOEs over the state budget can be reduced by the indirect subsidies channelled through the SOBs, and the extent and nature of subsidies given to the SOBs are less transparent to both outsiders and to the government itself. In addition, as established in Section 6.2.1, choosing this intermediate outcome is either unsustainable (if the equitisation and privatisation of the SOBs is allowed to continue) or will block the attempts to further the process of equitisation and privatisation of the SOBs. Given the combination of internal and external pressure upon Vietnam to continue and accelerate the Doi Moi reforms, neither of these situations appears attractive. The Vietnamese government should therefore carefully consider to abolish gradually all implicit and indirect subsidies given to the SOEs through the banking sector.

## 6.3 Financial Services to the Agricultural Sector

The Doi Moi reforms initiated in 1986 and in particular the Land Laws adopted in 1988 have led to a radical transformation of the Vietnamese agricultural sector.[45] The acceptance of the private family farms as the principal unit of agricultural production and the gradual introduction of rural non-farm enterprises resulted in a rapid and sustained increase in agricultural production for both domestic and export markets (the latter consisting mainly of rice, coffee, pepper and cashew). The drive to obtain and expand the full potential of the agricultural sector has in turn increased the pressure to establish a viable, market-based financial system for the rural farms and enterprises.

Following the initiation of the Doi Moi reforms the increased demand for financial services to the rural areas quickly led to the establishment of new specialized institutions predominantly directed towards servicing rural populations.[46] The government furthermore increased pressure on existing banks and mass organizations to increase their outreach in rural areas. This strategy has borne fruit. The share of rural households having access to credit rose from 9 percent in 1992 to 30 percent in 1994.

The current estimate is that about 60 percent of rural households have access to formal and semi-formal financial services[47] - an impressive increase in outreach in just little over a decade. The segments of rural populations who are still un- or under served with

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[45] The decollectivisation process was in fact initiated with Decree No. 100 already in 1981. It permitted the delegation of production responsibilities to individuals. It was, however, not the intention to replace production cooperatives with family based production units at this stage.

[46] This includes the Vietnamese Bank for Agriculture and Rural Development (VBARD) in 1990, the gradual establishment of Peoples Credit Funds (PCFs) from 1993 and onwards, and the Vietnamese Bank for the Poor (VBP) in 1996.

[47] In this context, ‘formal institutions’ refer to institutions under the jurisdiction of national banking laws, while ‘semiformal institutions’ covers all formal institutions, which are not subject to banking supervision. The PCF system is an example of a semiformal institution.

financial services include the ultra poor, people in remote areas,[48] and people who are not members of a mass organization.

The most important formal financial institution serving the rural areas is the Vietnamese Bank for Agriculture and Rural Development (the VBARD). Given its importance to this sector the VBARD is first considered separately in Section 6.3.1. Subsequently, Sections 6.3.2 to 6.3.5 consider a number of problems related to the tension created between the rapid increase in financial sector outreach, on the one side, and the historical legacy of a policy directed and tightly controlled mono-bank system, on the other. This has resulted in a number of structural problems, which urgently need to be addressed if the positive development in the agricultural sector is to continue. The three problems, which will be considered in detail here, are:

1. The lack of competition between financial institutions in effect serving separated segments of the rural population (Section 6.3.3).

2. The regulated and in some cases heavily subsidized interest rates, which among other things stifle financial innovation and restrict the formal institutions from obtaining sustainability (Section 6.3.4).

3. The limited mobilization of savings, which restricts the resource base and the outreach of the financial sector (Section 6.3.5).

Addressing these problems will involve profound structural changes in the rural financial sector. Long-term political commitment and allocation of resources is imperative. Failure to address either of these problems is, however, likely to have an adverse effects on the efforts of the agricultural sector to remain competitive both nationally and internationally.

### 6.3.1 VBARD

The VBARD was established on 26 March 1988 under the Law on Credit Institutions, and it has subsequently played a major role in the provision of investment capital to agriculture and rural areas. In terms of customers, the VBARD is the largest bank in Vietnam. In 2001, bank customers included 6,000 enterprises and 7.5 million business households. The VBARD also has the densest network of branch offices in Vietnam and a staff of more than 24,000 people. Total credit in 2001 was VND 60,054 billion, of

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[48] Three of the seven regions in Vietnam continue to lag behind. This includes the Northern Mountains and Midlands, the Central Highlands and the North Central Coast.

which medium and long-term credit accounted for almost 43 percent or VND 25,684 billion. Looking more closely at the distribution of VBARD credit in 2000, it can be seen that VND 37,818 billion or 63 percent was given to households in rural sectors, 21 percent or VND 12,614 billion went to SOEs, while privately owed enterprises received VND 3,211 billion amounting to 5.3 percent of total credit.

Only VND 92 billion or 0.15 percent went to the collective sector. A survey of a number of agricultural cooperatives shows that the majority of the surveyed cooperatives faced difficulties accessing credit from the VBARD because they lacked the assets required. In fact, many heads of cooperatives had to use their own assets as collateral to borrow capital for the cooperatives.

Classifying the lenders by their principal economic activity, the credit provided by VBARD in 2001 was allocated as follows (with shares of total credit in parenthesis)

- Agriculture: VND 29,306 billion (48.8 percent).
- Forestry: VND 390 billion (0.65 percent).
- Aquaculture and salt industry: VND 4,329 billion (7.21 percent)
- Industry: VND 5,224 billion (8.7 percent)
- Trade and services: VND 5,765 billion (9.6 percent)
- Other industries: VND 15,015 billion (25 percent).

The VBARD is assigned to carry out a number of national policy credit programmes. By the end of 2001, the results of implementing the following policy credit programmes were:

- Credit for the project on upgrading houses built on stilts in flooded areas: VND 930 billion (share of outstanding debts collected: 44 percent);
- Credit for the project on reducing adverse impacts of storm No. 5 in 1997: VND 841 billion (share of outstanding debts collected: 27 percent);
- Credit for the project on reducing adverse impacts of drought in 1998: VND 41 billion (share of outstanding debts collected: 40 percent);

- Credit for the project on reducing adverse impacts of floods in 1999: VND 135 billion (share of outstanding debts collected: 42 percent).

In addition, the VBARD is assigned to allocate capital to a number of government development projects. At the end of 2001, total capital granted to these projects was VND 843.9 billion. VBARD also extends a range of other financial services like lending to industrial zones, export processing zones, co-sponsored lending, guarantee and leasing.[49]

### 6.3.2 Lack of Competition in Rural Financial Markets

In Vietnam the lack of competition between formal and semi-formal rural financial institutions directly related to government policies and preferences as implemented through government controlled financial institutions. This becomes evident through the following summary of key characteristics of the three most dominant institutions, the Vietnamese Bank for Agriculture and Rural Development (VBARD), the Vietnamese Bank for the Poor (VBP) and the Peoples Credit Funds System (PCF).

**Table 6.5: Characteristics of institutions serving the agricultural sector**

| | VBARD | VBP | PCF |
|---|---|---|---|
| **Year of establishment** | 1988 as a department of former mono-bank. Became operational in December 1990. | Established in 1995 as a state owned, non-profit bank. | The Rural Finance Project began in March 1994. |
| **Mission statement** | The explicit focus of VBARD is on financing all types of enterprises in rural areas | The explicit intention is to eliminate hunger and alleviate poverty through the provision of small loans to poor households | The objective is to supplant the failed credit cooperatives and to restore confidence in the formal financial sector. |
| **Number of clients** | Above 4 million | About 2.2 million | Approximately 0.7 million |
| **Customer profile** | About 90 percent of all formal credit to rural households was handled by | Only people classified as poor are eligible for loans. Monthly income is | The following is known about the composition of members of PCFs: 66 |

[49] The VBARD owns and operates two of the financial lease companies mentioned in Section 6.1.1.5.

| Table 6.5: Characteristics of institutions serving the agricultural sector | | | |
|---|---|---|---|
| | **VBARD** | **VBP** | **PCF** |
| | the VBARD in 1997, although this share might include some handled by the VBP. | converted into rice value. Cut off values are: Urban areas less than 25 kg per person, rural areas under 20 kg, and in mountainous areas less than 15 kg | percent are farmers, 20 percent are rural traders and 11 percent are rural artisans and small-scale entrepreneurs.<br>15 founding members of a LCF have to buy shares amounting to VND 3,333 million per person, which can be paid in instalments over a number of years. Rank-and-file members have to buy a qualification share amounting to VND 50,000 |
| **Number of branch offices** | End of 1996 VBARD had 2,564 branch offices. In addition, mobile banking units are operating transaction offices at the commune level. The VBARD is one of the largest networks in Vietnam and the largest provider of credit to the rural sector. | Use infrastructure and staff of the VBARD. VBP furthermore collaborates with other organizations (ministries, mass organizations, etc) for screening, supervision and support for the groups | In September 1998 there were 988 People's Credit Funds established in 35 of Vietnam's provinces.<br>The total number of members exceeded 600,000 in September 1998. |
| **Portfolio of financial products supplied** | Only short to medium term credit has been available. Short-term lending accounts for two-thirds of all credit in 2001.<br>Possible collateral is: land-use-rights, real estate and durable consumption goods | Only one product: A 2-5 year loan without collateral. Interest is payable in monthly instalments but the principal should not be paid before the end of the loan period.<br>In most cases credit is not handed over in cash but in kind. | The loans are small loans mainly geared toward production. Only consumer goods are accepted as collateral – not land use rights. |

The mission statements and the mode of operation of the reviewed institutions provide an explanation for the lack of competition between the rural financial institutions. Exercising significant direct control over all three institutions, the government has laid down an explicit division of labour towards providing financial services for all income segments of the rural population.

In addition, the local communes, people's committees and mass organisations play a crucial role in the identification, screening and follow-up on clients for each type of institution. The result is that the initiative to form joint-liability groups and/or to contact potential lenders comes from the institutions themselves. This is a top-down approach which originates in a desire to divide the market between the institutions in order to extend their outreach. The segments served by the three institutions can be summarized as follows:

**VBARD** Up until 1995 the primary clientele of VBARD was the medium and well-to-do farmers, who could provide collateral. Starting from 1995 the VBARD introduced joint-liability groups where small loans are processed via groups. In 1997 about 150,000 joint liability groups are supported. This initiative has to some extent made VBARD credit available to less-well-off households, but the majority of the clients still remain in the upper income segments of the rural population.

**VBP** As indicated by its name and the requirement to lend only to people classified as being poor, the VBP serves the less well off segments. The restriction to supply only one financial product has, however, been found to restrict the ability of VBP to reach the very poor. These destitute households have frequently been found to regard VBP loans of typically VND 1-2 million as being too large. The reports of poor households actually turning down loan offers are, according to the ADB, 'legion'. In addition, many poor households oppose the special repayment structure of VBP loans. Many households assess that the postponement of the payment of the principal until the end of the loan period represent too high a risk; many would in fact prefer small and frequent instalments of both principal and interest.

Another factor contributing to the exclusion of the very poor from the formal financial system are the transactions costs when applying for a loan.

**PCFs** The PCFs require borrowers to buy shares, and the implicit screening mechanisms have been built in through the use of local peoples committees and the practice to pay out loans in kind. This implies that the PCF system predominantly caters for the better off households – in effect excluding poor households who are left with a choice between the VBP and informal finance.

In evaluating the potential negative effects of this lack of competition it is, however, important to point out that financial sector analysts are divided on the question of how important increased financial sector competition is.

One group of analysts is of the opinion that lack of competition will have adverse effects on financial sector performance and development, including limited financial innovation, lack of incentives to reduce costs and poor quality of services. Another group of analysts points to panel data analyses (Demirgüz-Kunt & Detragiache 1998), which suggest that banking sector fragility often increases as a result of the erosion of franchise values that frequently follow from financial sector liberalisation. The key problem is that the countries in question frequently fail to build an appropriate institutional framework for the supervision and regulation of the financial sector. As a result governments find it difficult to curb and control bank behaviour. Banks whose franchise values are eroded shift to riskier business strategies in an attempt to gamble for their resurrection. In many developing countries the end result is costly financial sector crises.

The dispute over whether or not financial sector liberalisation is beneficial has led to the emergence of alternatives to financial liberalisation and increasing competition. Hence, Hellmann, Murdock and Stiglitz (2000) propose an alternative strategy of financial restraint. One basic aspect of their model is that creating profit opportunities for banks will result in banks becoming more stable institutions with better incentives for monitoring borrowers. This in turn will reduce the moral hazard problems when banks imprudently gamble for their survival. As a result overall financial sector stability will improve.

The question of which approach will be suitable for the Vietnamese rural financial sector is not an easy one to answer. The overall lack of transparency in the financial sector (in combination with non-standardised accounting procedures) obstructs attempts to evaluate the frailty of the individual institutions.

### 6.3.3 Interest Rate Regulation

Interest rates in the institutions serving the rural sector are heavily subsidized and subject to close government control. The provision of subsidized interest rates has for a long time been a point of discussion between the donor community and the government of Vietnam.

The donor community points to international experience with subsidized rural credit programmes in LDCs, which have resulted in massive loan losses, low savings mobilisation and heavy losses to both governments and international donors. In addition, subsidised credit programmes have been found to lead to lacklustre market discipline. They have also had detrimental effects on lending behaviour and managerial competencies and incentives. This has, among other things, led the donor community to refrain from refinancing the VBP.

The government of Vietnam, on the other hand, has maintained subsidised interest rates as part of a policy to ensure equitable growth, redistribution of wealth and poverty alleviation. The government indicated willingness to reconsider existing policies during a consultative donor meeting in December 2000. This will, however, take time, implying that evaluating the effects of subsidizing interest rates remains highly relevant. The following negative effects of operating with subsidised interests rates can be identified:

**Damaging perceptions of credit**. The subsidized low interest rates lead to a rush for loans from VBP and VBARD. While there is no evidence that subsidized loans saturate the demand for credit, the cheap loans reinforce a common impression that the low interest loans are a right and not a contractual agreement. In addition, the perception that loans at a higher rate are exploitative makes a shift back to market-based rates increasingly difficult (ADB 2002).

**Obstructing the mobilisation of savings**. The cap on lending rates (in combination with the generally high operating costs, which follow from expanding outreach in rural areas) implies that banks have limited margins. This makes it difficult for them to raise savings rates without incurring a loss.

**Lowering the quality of financial services**. The above-mentioned low margins lead to transformation of the credit culture, which make it cruder and stripped of additional services. This has a detrimental effect upon the innovative, timely and balanced provision of financial services. In addition, banks seek to shift obligations (preparation and training of customers, pre-screening of loan applicants, collection of borrower payments, and client supervision) on to clients or their intermediary structures (mass organizations) in order to save costs. This leads to less focused development of skills and knowledge within the financial institutions.

On the positive side, it has been pointed out that subsidizes interest rates imply that the psychological barrier of poor households toward taking a loan is lowered. This may be true in some cases. It is, however, important to point out that the above-mentioned study of borrower transaction costs in the Red River Delta indicates that very poor households (who typically need small loans) are likely to prefer a loan from the informal sector.

In addition, existing evidence indicates that the assumption that the interest rate offered is a crucial factor for sustainable lending to poor households is incorrect. The ADB recently visited a number of Micro finance credit projects in Vietnam. Everywhere staff emphasized that a minimum of guidance and training of the poor was needed in order for them to be able make profitable use of loans. This is a lesson, which has emerged from a number of projects directed at providing credit to poor households, including the much publicized and copied Grameen Bank in Bangladesh. One German NGO (Misereor) operating in Vietnam has introduced a special training margin of 0.1 percent, which is built into the interest rate to cover the cost of training and guidance. This is a model which the affiliated lenders are reportedly quite satisfied with.

In conclusion, the significance of the reduction of the psychological barrier towards loans in poor households is doubtful, and one can conclude that the effects of operating with subsidized interest rates are likely to be predominantly negative.

### 6.3.4 Savings Mobilization

Mobilizing savings was not a focus area for financial institutions until the late 1980s and subsequent attempts to strengthen the performance in this area have generally been moderately successful, at best. Total domestic savings channelled through the formal system have risen from 16 percent to 23 percent of GDP in the period from 1993 to 1999. However, this is insufficient vis-à-vis the need to extend outreach of financial services to remote and mountainous areas. The same can be said for the possibility of obtaining long-term sustainability. Neither of these aims can be obtained as long as government funding is the main source of funding. In addition, total domestic savings in Vietnam as a share of GDP remains far below that of other countries in the region, and considerable fluctuation in the total savings as a share of GDP has been recorded.

The general picture of limited success in mobilizing savings can be attributed to both supply and demand factors, which are, in some areas, mutually reinforcing.

On the supply side, the historical legacy of negative real interest rates during the mono-bank era and the collapse of the rural credit cooperatives in 1990-91 have implied that the Vietnamese can be characterized as being deeply suspicious of banks. They prefer to keep money in assets with a high degree of liquidity. This can be illustrated with the 1992-93 Vietnam Living Standards Survey (VLSS). Here it was found that only about 7.4 percent of total savings was deposited in banks. Some 44 percent was invested in gold. Another 20 percent went into real estate, and more than 10 percent was kept in cash.

On the demand side, government financing of the rural financial institutions, in combination with the low interest rate margin dictated by the government, reduces incentives to mobilize savings.

However, turning focus to the performance at the institutional level reveals considerable differences across the major state-controlled institutions. The PCF system has been the most successful in mobilizing savings. By the end of 1996 – only two years after coming into operation – the average savings per member amounted to US$ 170. This is remarkable given the fact that average per capita income in rural Vietnam at that time was approximately US$ 100. Part of the explanation is that the founding members and the majority of the rank-and-file members belong to the upper income quintiles. However, one should also notice the following factors, which undoubtedly contributed to the relatively successful mobilization of savings:

- Deposit insurance is available for deposits with terms exceeding three months.
- The deposit rate offered is higher than those of other financial institutions.
- The proximity and relative autonomy of the PCF in combination with the partial local ownership and involvement in management is likely to lessen otherwise widespread distrust towards formal financial institutions.
- The accessibility and local presence make it convenient to deposit and/or withdraw funds. In addition, paper work and bureaucracy is kept to a minimum.

Turning to VBARD and VBP, the track record, however, turns less positive. Generally, both VBARD and VBP do not envisage savings and savings accounts as an essential element of their business plan and mode of operation. Consequently, savings are not a prerequisite for obtaining loans, and savings do not automatically enter the assessment of a potential borrower in the two institutions.

## 6.4 Concluding Remarks

Chapter 6 has provided a brief overview of the most significant formal and informal financial institutions active in the Vietnamese financial market. In addition, we analysed existing constraints and inherent tensions in the process of transforming the state-owned commercial banks into autonomous institutions guided by market principles and forces. Introducing a very simple typology of intermediate outcomes for this transformation, the Vietnamese approach can be characterised as allowing the SOBs to pursue an overall objective of profit maximisation vis-à-vis their non-government customers. At the same time, the government reserves the right to stipulate the terms and conditions under which the SOEs receive credit. This in effect amounts to the government transforming bank profits made on private customers into subsidies to the SOEs. As a consequence, any direct subsidies given to SOEs over the state budget can be increased by the indirect subsidies channelled through the SOBs. Moreover, the extent and nature of subsidies given to the SOBs are less transparent to both outsiders and to the government itself. In sum, this approach is neither sustainable nor in accordance with the process of equitisation and privatisation of the SOBs.

Turning to a more specific analysis of the financial sector performance vis-à-vis the agricultural sector, it was found that the government has in effect laid down an explicit division of labour between the different financial institutions which provide financial services to the rural population. In addition, the local communes, people's committees and mass organisations play a crucial role in the identification, screening and follow-up on clients for each type of institution. The result is that the initiative to form joint-liability groups and/or contact to potential lenders come from the institutions themselves. This reflects a top-down approach, which most likely originates in a desire to divide the market between the institutions in order to extend their outreach.

The competition and segmentation on the rural financial markets is further hampered by the widespread practice of offering subsidized interest rates. While this approach is chosen to improve development opportunities for the rural population, the net effects of this policy are likely to be negative and detrimental to the overall purpose of improving the livelihood of rural populations. In addition to restricting the mobilisation of savings, the practice of subsidizing interest rates damages customer perception of credit, lowers the overall quality of financial services, and reduces the quality of investment projects financed through the financial sector. All this runs counter to the government desire to develop and create growth opportunities for the agricultural sector.

# 7 Conclusion

The eclectic nature of the topics and issues analysed in this report renders attempts to reach an overall conclusion difficult. Yet, the recent gradual reactivation of more comprehensive and fundamental financial sector reforms in many respects represents the end of the beginning rather than the beginning of the end of reforms. The majority of the fundamental and far-reaching reforms are still at an initial stage and have yet to be considered. Thus, the official commitment and resolve towards reforms in Vietnam remains to be fully tested. The Vietnamese government holds the key to further reforms, but one can identify at least two reasons for the persistent government reluctance towards further liberalising the financial sector.

1. The financial sector represents a nexus of control reaching almost all sectors in the economy. This enables the government to raise subsidies (see Section 6.2) and allocate funds to special programmes and state-owned enterprises (see Section 6.3).

2. The non-performing loans in the financial sector and the state-owned banks in particular represent 'an uncollected bill' for lack of efficiency and/or failures in especially the state-owned enterprises in the past. Depending on their true magnitude, addressing and resolving the problem of non-performing loans held by the SOCBs can result in the destabilisation of both the financial sector and the economy at large (see Section 5.5). While this should not be accepted as an excuse for failing to address the problem in a gradual and transparent manner, it is clear that the Vietnamese government will think twice before risking squandering its hard-gained performance legitimacy (see Section 3.2).

Both these factors are domestic in nature, which makes it clear that any desire and perceived need for in depth reforms have to come from within the Vietnamese government itself. This does not, however, imply that all reforms are blocked and that non-governmental agencies and observers should refrain from doing anything.

An important decision, which has been touched upon in a number of contexts, is whether Vietnam should opt for the market-based approach (as in the US) or the German-inspired bank-based model. As illustrated by the descriptions included in this report the Vietnamese equities and securities markets are nascent or non-existing. This makes the option of a market-based system a long-term prospect rather than a realistic alternative. In addition, various analyses, Gibson and Tsakalotos (1994) and Levine (2002), recommend an intermediate approach for developing countries. Thus, instead of perceiving it as a choice between two competing systems, early developers and countries in transition should seek to establish a strong institutional regulatory and supervisory framework. This should enable their typically bank-based system to establish and grow prior to a gradual, long-term adaptation and development of a more market-based system. Levine (2002) is able to support the recommendation with recent cross-country empirical analyses. They indicate that 'neither market-based nor bank-based financial systems are particularly effective at promoting growth'. Instead, Levine suggests that developing and transitional countries should aim at strengthening the rights of investors and the efficiency of contract enforcement. He argues that it is 'less useful to distinguish financial systems by whether they are bank-based or market-based than it is to focus on the specific laws and enforcement mechanisms that govern both debt and equity transactions.'

The view that the specific laws governing financial sector activities are of importance is generally in accordance with observations and policy recommendations made in this report, including that:

- The Vietnamese legislation is equal to or outperforms that of other countries of the region. However, the autonomy and power to rapidly implement these laws is lacking in relative terms.
- The type of activities banks can engage in Vietnam is relatively restricted. Banks in Vietnam are, for example prohibited from engaging in securities, insurance and real estate markets. These activities are permitted or only somewhat restricted in most other developing countries.
- The accounting standards of banks in Vietnam are below the average level of developing countries.
- The requirements about the amount of capital that bank must hold are very restrictive in Vietnam compared to other countries in the region.

Moreover, this report has focused on the enforcement mechanisms and powers of the central regulatory and supervisory institution in the Vietnamese financial market, namely the SBV. It is concluded that the SBV at present cannot effectively develop and execute national monetary policies. It is still operationally and politically dependent upon support from other government agencies. Hence, although some experts view the 1998 Law on the State Bank as a step backwards in terms of restricting stipulated independence compared to the situation prior to the passing of the law, it appears more likely that lack of especially political but also operational independence are at present the more binding constraints.

As a consequence, it is recommended that the pursuit of increased central bank independence in Vietnam should focus more on the indirect route. This entails a gradual build-up and strengthening of a non-governmental lobby for an independent central bank. The preliminary plans for the equitisation of the large state-owned banks represent an important step in this direction, as does the continued presence of foreign banks in Vietnam. In addition, it is recommended that the Vietnamese government consider complementing the indirect approach with more direct measures directed at limiting local interference in credit institution activities. This should aim at improving the overall transparency and predictability of the political interference, which takes place. In addition, the government should consider the creation of a separate institution responsible for financial sector supervision. This would most likely strengthen the autonomy and independence of both the SBV in the conduct of its remaining central bank duties and the new supervisory agency. The latter would not share a common background and former affiliation with some of the principal objects of supervision and control, namely the SOCBs. Whether or not the Vietnamese government is prepared to commit itself to these developments is an open question. It is, however, important that they are considered and discussed in relation to the planned evaluation of supervisory practices of the State Bank of Vietnam.

The role of historic factors and path dependency has been identified and analysed throughout in this study. Not surprisingly, important historic influences were identified in almost all areas discussed ranging from the French legal tradition in Chapter 4 to the legacy of central coordination in Chapters 3, 5 and 6. In this context, it is important to stress that the presence of historical determinants does not necessarily imply that direct actions to undo the past and/or change historic structures should not be considered. In many cases, the presence of specific historic influences is mentioned. Policy-makers and market participants should take them into account in planning, leading to more indirect reactions.

In conclusion, the analysis presented in this report underlines that liberalising financial markets is not solely a question of limiting and/or restricting government influence, in some areas such as, for example, the regulation and supervision of the financial markets. It might in fact be that the opposite is true, namely that the influence and power of government controlled institutions should be increased and strengthened, but through different channels of influence.

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